

Ending a Role

International Monetary Reform and the Retirement of
Sterling, 1967-1977

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Abstract

The thesis traces the retirement of sterling as a reserve currency amid the profound transformation in the international monetary system that occurred between the 1967 devaluation and the 1977 Third Group Arrangement. Despite contemporary concern that sterling's reserve role acted as a constraint on the domestic economy, paradoxically the period prior to the 1976 IMF crisis witnessed a renewed accumulation in sterling balances. The thesis explains this process using a constructivist approach to monetary relations, arguing the nature of the external constraint and strategies for resolving sterling's reserve role were constituted by Britain's normative commitments to the international monetary system. The sterling balances were of continued use to British policymakers in securing their traditional objectives of stability in external exchange and autonomy in domestic policy. Despite nominal commitments to retire sterling's reserve role, this was expected to take place as part of wider international monetary reform. The external constraint was in a constant process of reconfiguration as Britain adjusted to the evolution of the monetary system, while international support helped negotiate the impact of policies that preserved the sterling balances. Only in 1976 in response to the culmination of the reform process and growing ideological divergence with the crucial American source of support did resolving sterling's reserve role take priority in policy. The thesis reconstructs the process of policy formation and economic diplomacy to trace the strategy of retiring sterling via monetary reform. Between 1967 and 1970, the external constraint was constituted by adherence to Bretton Woods, in which defence and reform of the system took priority over retiring sterling. Defending the post-devaluation rate required economic retrenchment, excessive borrowing and expensive inducements to sterling holders that facilitated a renewed build up in the balances. The greater flexibility of the system following the 1971 Nixon Shock allowed Britain to expand domestic autonomy, prioritising domestic growth over sterling stability and refusing any new obligations for sterling. A further accumulation in the balances followed the 1973 oil crisis as Britain prioritised maintaining output and employment. However by 1976 Britain's traditional recourse of the IMF to provide liquidity amid a shift in market confidence was threatened by the neo-liberal prescriptions of the US Treasury and American frustration that Britain's ability to defer adjustment through drawing on the sterling balances was undermining calls for a common front against the oil producers. Amid a conflict over the nature of the crisis and the role played by the balances, Labour finally prioritised resolving the reserve role, accepting agreement with the IMF as the price of securing American backing of a wider support package. The true significance of the IMF crisis is reinterpreted as the reduction of sterling held abroad to working balances.

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I owe a great deal of thanks to Professor Scott Newton for his support and encouragement throughout the project. His knowledge of the period and his technical expertise proved invaluable. I can only apologise for not completing the thesis in time before his retirement and hope he can find the time to read to finished product having spent the last 5 years of his career overseeing it.

I also would like to thank Dr. Gerwin Strobl for his support in seeing me across the finish line. He provided an additional perspective from which to view the thesis and also corrected me on my numerous grammatical mistakes. Needless to say, any that remain are the fault of myself alone.

Finally, my parents provided emotional and physical support throughout my time as a student. I would like to dedicate the thesis to them and hope it makes them proud.

List of Abbreviations

AES	Alternative Economic Strategy
BIS	Bank for International Settlements
CAP	Common Agricultural Policy
DCE	Domestic Credit Expansion
DM	Deutschmark F
EY	Ministerial Committee on Economic Strategy
EMCF	European Monetary Cooperation Fund
EMU	European Monetary Union
FSF	Financial Support Fund
GAB	General Agreement to Borrow
G10	Group of Ten
GDP	Gross Domestic Product
IMF	International Monetary Fund
LDC	Less Developed Countries
MLR	Minimum Lending Rate
MSP	Minimum Sterling Proportions
NSA	Non Sterling Area
OPEC	Organisation of Petroleum Exporting Countries
OSA	Official Sterling Area
PCC	Policy Coordinating Committee
PSBR	Public Sector Borrowing Requirement
SDR	Special Drawing Rights
VCU	Vehicular Currency Unit

Chapter 1

Introduction

The 1967 devaluation of sterling and the 1976 IMF bailout negotiations are two of the most intensively studied periods of Britain's post-war economic history. Despite this level of interest however, these events are rarely linked in the historical narrative. Devaluation in 1967 is considered the end of the Labour government's attempt to defend the rate after assuming power in 1964, while the subsequent struggle back to stability over the next two years has usually been taken as a post-script of less importance.¹ While the devaluation can thus be said to have had short historical consequences, the IMF bailout has short antecedents, with the analytical record generally looking no further back than the Barber Boom and 1973 oil crisis as an explanation for the predicament Britain found itself in by 1976. Debate has instead centred over the extent to which Labour's economic retrenchment constituted a break with the post-war consensus and whether it was adopted internally or imposed on Britain by IMF conditionality.²

¹ On devaluation see: Alec Cairncross and Barry Eichengreen *Sterling in Decline: The Devaluations of 1931, 1946 and 1967* second ed. (Basingstoke: Palgrave Macmillan, 2003); Tim Bale "Dynamics of a Non Decision: The 'Failure' to Devalue the Pound, 1964 – 67." *Twentieth Century British History* (1999) Vol. 10 (2); Scott Newton "The Two Sterling Crises of 1964 and the Decision Not to Devalue" *The Economic History Review* (2009) Vol. 62 (1); Michael J. Oliver "The Management of Sterling 1964 – 1967" *The English Historical Review* (2011) Vol. 126 (520)

² On the IMF crisis see: Kathleen Burk & Alec Cairncross *Goodbye Great Britain: The 1976 IMF Crisis* (New Haven: Yale University Press, 1992); Mark D Harmon *The British Labour Government and the 1976 IMF Crisis* (Basingstoke: Palgrave Macmillan, 1997) ; Douglas Wass *Decline to Fall: The Making of British Macro-Economic Policy and the 1976 IMF Crisis* (Oxford: Oxford University Press, 2008); Kevin Hickson *The IMF Crisis of 1976 and British Politics: Keynesian Social Democracy, Monetarism and Economic Liberalism: the 1970s Struggle in British Politics* (London: Tauris Academic Studies, 2005); Richard Roberts, *When Britain Went Bust: The 1976 IMF Crisis* (London: OMFIF, 2017)

As such the historical record has generally overlooked a continuous narrative running from sterling's devaluation in 1967 through to the aftermath of the IMF crisis in 1977, in which a major source of concern for British policy was the overhang of short-term sterling liabilities to assets, the so-called sterling balances. Taking place at a time of fundamental revision to the world's international monetary system (in short from a gold based, pegged-rate exchange standard to a dollar based fiat, floating one), British policymakers attempted to navigate the increasingly crisis prone global economy. The role of this thesis is therefore to fill a gap in the historical record by tracing the consequences of the 1967 devaluation, via the breakdown of the Bretton Woods monetary system and a renewed accumulation of sterling balances held abroad, directly to the 1976 IMF crisis. In contrast to analyses focusing solely on the 1976 IMF negotiations, the thesis argues that these events can only be truly understood in the context of parallel negotiations initiated by Prime Minister Jim Callaghan aimed at resolving sterling's reserve role, which drew on the experience of international reform since 1967. It therefore reappraises IMF conditionality as a *quid pro quo* to secure American backing for an additional support package in which the true significance of the crisis was the final resolution of the sterling overhang and the reduction of foreign holdings to working balances.

Structural accounts of international monetary relations argue the growth in global capital flows and sterling's continued international role combined to act as a constraint on domestic policy autonomy (particularly for left wing governments), requiring they prioritised measures that stabilised sterling and restored market confidence at the expense of commitments to faster economic growth.³ In contrast the thesis presents an constructivist interpretation of the impact of sterling's international role, arguing it was constituted by British commitments to the principles of embedded liberalism which aimed to combine stability in external exchange with domestic policy autonomy. While adherence to the international monetary system's provision of adjustment, liquidity and confidence

³ David M. Andrews "Capital Mobility and State Autonomy: Toward a Structural Theory of International Monetary Relations," *International Studies Quarterly* (1994) Vol 38 (2) pp.193 – 196.

could act as an external constraint on domestic policy, this proved amenable to negotiation through economic diplomacy aimed at securing beneficial reforms and tailored support packages for sterling. These commitments and sources of support meant sterling's reserve role continued to be of use to British policymakers' wider objectives of securing systemic stability and preserving autonomy into 1975; prioritisation of reducing the sterling overhang was taken only following the culmination of wider reform process that failed to resolve sterling's international role, combined with the growing ideological divergence with the crucial American relationship that resulted in more contentious negotiations with institutional sources of support.

1.1: The Sterling Balance Constraint

Throughout the post-war period, questions of economic decline were entwined with the persistence of Britain's international role, including the continued use of sterling as a reserve currency. Although the vast expansion of the dollar's use internationally meant sterling's share of global foreign exchange reserves had declined from over 55% in 1950 to under 5% by 1976, for members of the Official Sterling Area [OSA] it continued to play an important role.⁴ Their commitment to hold sterling had depended initially on British imperial control, but had subsequently come to rely on the contribution made by Britain to mutual defence, coupled with concessions on trade and access to the City of London.⁵ Over time however, decolonisation, military retrenchment and Britain's growing reorientation towards Europe had weakened the links between Britain and the OSA.⁶

By the time of the 1967 devaluation, sterling's international role was perceived domestically as a constraint on growth.⁷ Throughout the 1960s, domestic expansion resulting in current account deficits had threatened diversification of the sterling balance holders which could potentially

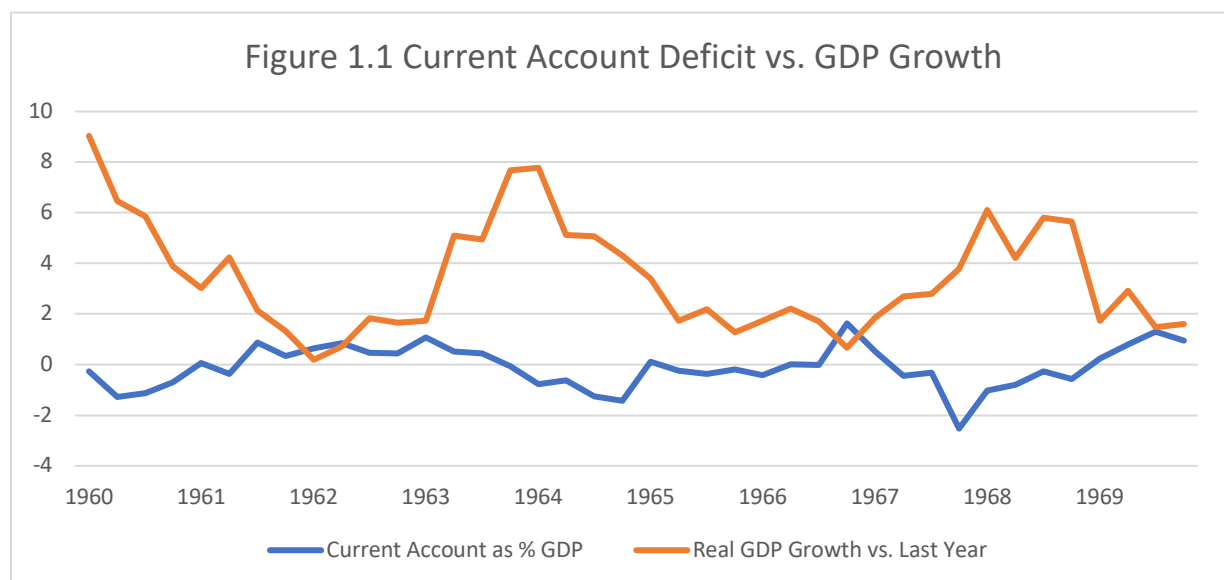
⁴ Catherine Schenk *The Decline of Sterling. Managing The Retreat of an International Currency, 1945-1992* (Cambridge: Cambridge University Press, 2010) pp.22-23

⁵ Catherine Schenk "The Sterling Area and Economic Disintegration" *Geschichte und Gesellschaft* (2013) Vol. 39 (2) p. 181

⁶ Susan Strange *Sterling and British Policy: A Political Study of an International Currency in Decline* (Oxford: Oxford University Press, 1971) p5

⁷ Fred Hirsch *The Pound Sterling: A Polemic* (London: Gollancz, 1965) p14

overwhelm Britain's correspondingly short-term assets. In response, the government would be forced to slow expansion in order to reduce the external deficit and restore confidence in the currency. This 'stop-go' cycle was compared unfavourably with the economic miracles occurring in continental Europe.⁸ (See Figure 1.1)



Source: Office of National Statistics. Current Account Balance, Seasonally Adjusted [HBOP], Gross Domestic Product at Market Prices, Seasonally Adjusted [YBHA], Gross Domestic Product Chained Volume Measures [ABMI]. Accessed Online

Traditional accounts have explained sterling's continued use abroad either by referring to the 'delusions of grandeur' of statesmen seeking to prolong an international role long after Britain ceased to be able to afford it, or the priority given to the interests of the City over industry which were held to depend on foreign use of sterling.⁹ In contrast, the thesis argues that the continued existence of the sterling balances, in particular the fresh accumulation that followed devaluation, reflected the use policymakers made of the balances in securing other economic goals. As such the 'problem' that Callaghan sought to resolve in his approach to the IMF crisis was in part constituted by the accumulated decisions made by governments of which he had been an integral part.

⁸ Michael Stewart, *Politics and Economic Policy in the UK Since 1964: The Jekyll and Hyde Years* (London: Pergamon, 1978) p134

⁹ See extended discussion in Chapter 4; *Strange Sterling and British Policy* p47

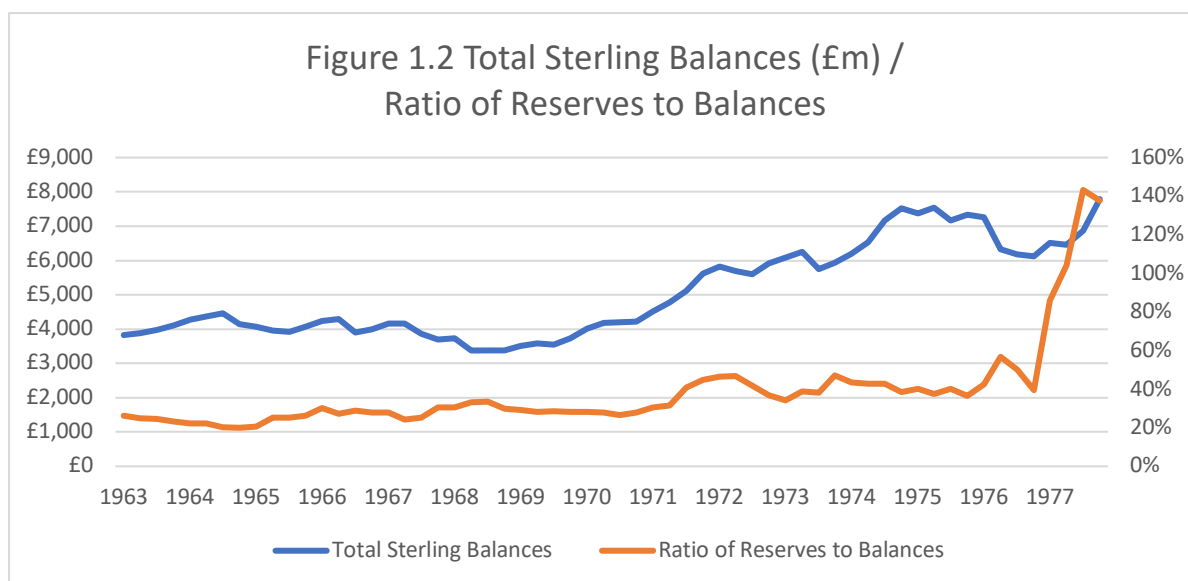
The problem of the sterling balances was one of liquidity, not insolvency and hence related to wider concerns over the international monetary system. As a memo written two days before devaluation complained, "We are, in fact, a very large net creditor in the world. But why does nobody else behave as though we were?" in reference to the imbalance in Britain's investment portfolio. The bulk of Britain's external assets were relatively illiquid long-term investments that could not be called upon to counter diversification by the sterling balance holders. As the memo ruefully concluded:

This imbalance is no more than saying that while we do not have much to show in the window, we have a lot in the store room, but unfortunately, we do not have a key to it.¹⁰

The shared, inter-subjective interpretation that the structure of British assets and liabilities meant stability was threatened by diversification marked sterling as a weak currency. In response, British economic diplomacy sought to develop the sources of liquidity available to finance diversification, both as part of general reforms to the international monetary system and through packages tailored for sterling. The objective of the thesis is to trace the process by which British leaders managed this process and the relative priority they gave to actively reducing the amount of sterling held aboard. This culminated in the 1977 Third Group Arrangement, negotiated immediately after then 1976 IMF deal which resulted in the overhang being eliminated but not before a renewed accumulation of balances had taken place following devaluation as policymakers prioritised wider Bretton Woods reform and commitments to domestic growth (Figure 1.2).¹¹

¹⁰ TNA FCO 2/679 "Growth and the Balance of Payments" 17 November 1967

¹¹ A. P. Thirlwall and Heather D. Gibson *Balance of Payments Theory and the United Kingdom Experience* (Basingstoke: Palgrave Macmillan, 1991) pp. 52 - 55



Source: Bank of England, *Quarterly Bulletin* 1974 Q2 “Overseas Sterling Balances 1963 – 1973” 1974; Bank of England *Quarterly Bulletin*, 1975 Q1 “Table 21: Reserves and related Items, Table 25: Exchange Reserves in sterling; and banking and money-market liabilities in sterling to holders other than central monetary institutions”; Bank of England *Quarterly Bulletin* 1977 Q1, “Table 19, Exchange Reserves in sterling; and banking and money-market liabilities in sterling to holders other than central monetary institutions, Table 23: Reserves and related items”; Bank of England *Quarterly Bulletin* 1979 Q1 “Table 15: Exchange Reserves in sterling; and banking and money-market liabilities in sterling to holders other than central monetary institutions Table 16: Reserves and related items,”

1.2 Contribution of the Thesis

The thesis fills a gap in the literature by examining the ongoing search for a resolution to the sterling overhang that took place between the 1967 devaluation and the 1976 IMF crisis. While both events have received voluminous analysis, the period in between has only recently begun to receive detailed historical investigation.¹² The most notable contribution in this area has been Catherine Schenk’s work on sterling’s post-war evolution. Her 2012 book *The Decline of Sterling: Managing the Retreat of an International Currency* advanced the revisionist thesis that the continuation of sterling’s international role was based on the demands of the world’s monetary system rather than the ‘delusions of grandeur’ trope used by many previous writers. Moreover, she argues sterling’s

¹² For example see Michael J. Oliver & Arran Hamilton “Downhill from Devaluation: The Battle for Sterling 1968 - 1972” *Economic History Review* (2007) Vol. 60 (3); Arran Hamilton “Beyond the Sterling Devaluation: The Gold Crisis of March 1968” *Contemporary European History* (2008) Vol. 17 (1); Scott Newton “Sterling, Bretton Woods and Social Democracy 1968 – 1970” *Diplomacy and Statecraft* (2013) Vol 24 (3); Alain Naef “Sterling and the Stability of the International Monetary System, 1944-1971” (Unpublished PhD Thesis, University of Cambridge, 2018);

weakness was successfully leveraged to secure international support for the currency with which Britain managed its integration into the expanding global economy, revising the traditional understanding that sterling's reserve role acted as a constraint on domestic growth.¹³

The thesis builds on Schenk's analysis by using a narrative approach to demonstrate how Britain's external constraint was not constant between these crises but was constituted by Britain's normative commitments to the evolving international monetary system. The size of the balances and the danger they posed to sterling at any time depended on the nature of these commitments. Likewise, the availability and conditionality of international support targeted at resolving the sterling overhang also evolved with the wider monetary system. The success or otherwise economic diplomacy had in convincing foreign partners of the systematic threat posed by sterling diversification, the progressive American attainment of its objectives for a more flexible system as well as growing ideological divergence between Britain and this crucial source of support all influenced the extent to which Britain could negotiate the external constraint with international support.

The thesis demonstrates that throughout the period between 1967 and 1977 governments expressed continued concern with the sterling overhang and looked to economic diplomacy to resolve it. However, prior to 1976 approaches to do so were determined by other foreign economic policy goals which influenced the danger posed by the sterling balances and the support available to mitigate it. Only in 1976 did resolving it become the priority of the government in return for coming to terms with the IMF. Between 1967 and 1970, the commitment to defend and reform Bretton Woods assumed priority over running down the balances. The thesis repositions the period following devaluation rather than 1976 as the period of greater external constraint and adjustment. This was due to the priority given to stabilising Bretton Woods, which required assuming more debt to defend

¹³ For a more detailed exposition of Schenk's views see the literature review in Chapter 3; Schenk *The Decline of Sterling* p204

the rate, greater proportional retrenchment in government borrowing and a fresh accumulation of the sterling balances. Despite the less acrimonious debates with the IMF than in 1976 (due to a shared Anglo-American commitment to the monetary system), the position of sterling was more constrained than later by the commitment to defend the post-devaluation rate and the more limited supply of international liquidity.

Despite the stabilisation of sterling in the early 1970s, the prospect of the overhang remained a source of concern, in which Edward Heath's Conservative government looked to Europe as a source surrogate of support due following the unilateral nature of the Nixon Shock. Schenk does not focus on sterling's European role following accession to the EEC in 1973, noting only that Europe proved "cold comfort" for Heath and that his attempt to secure a European solution to the sterling balances was dashed.¹⁴ The thesis undertakes a more detailed investigation of Heath's engagement with plans for European monetary union, arguing in contrast to his reputation as the most pro-European Prime Minister, in monetary relations Heath attempted to 'go-it-alone.' His refusal to assume any new obligations for sterling following the collapse of Bretton Woods that would constrain his expansionary domestic policies represented the prioritisation of domestic growth over commitments to resolve the sterling balances, resulting in an over-exposed current account even prior to the 1973 oil crisis.

Labour's return to power in 1974 amid the stagflation of the oil crisis initially saw a prioritisation of maintaining output and demand over inflation, in which a fresh accumulation of sterling balances among oil producers was encouraged as a means of offsetting the expansion of the current account deficit. In response, Labour looked to expand the institutional sources of finance available to sterling and Denis Healey enjoyed success in leading European opinion to secure an IMF facility to fund oil related balance of payments deficits. While this expanded the range of support available to sterling, other developments had less beneficial effects. The thesis also shows how the parallel process of

¹⁴ Schenk *The Decline of Sterling* p326, 346

international monetary reform shaped the availability and conditionality of these support packages for sterling. While Schenk concludes her discussion on international monetary reform with the failure of the Special Drawing Rights [SDRs] to establish a realistic alternative to reserve currencies, the thesis continues to the amendments of the IMF's Articles of Agreement in 1976 that formalised floating and the demonetisation of gold.¹⁵ While not directly related to sterling, the attainment of a more flexible system allowed America to more effectively contain sterling crises than under Bretton Woods, initially using this scope to push for greater British economic adjustment via IMF mandated conditionality. Paradoxically however, the new flexible system also allowed America to resolve sterling crises more cheaply than before, now that it could create dollars without regard to its own gold reserves.

In response therefore to the failure of wider international monetary reform and the growing ideological divergence between the British and American Treasuries, 1976 saw resolution of sterling finally take priority in economic diplomacy. The IMF crisis is therefore positioned as the culmination of a process that had begun with the devaluation of sterling, rather than a prelude to Thatcherism. Despite the controversial role of IMF conditionality as the neo-liberal US Treasury attempted to impose a policy change on Britain, the real significance of the crisis was the parallel deal on the sterling balances agreed with the Bank of International Settlements [BIS] that facilitated a reduction in foreign holdings of sterling to working balances. In contrast to analyses that interpret agreement with the Fund as a break with post-war policy, the thesis positions it as a continuation of strategy Labour applied following devaluation, in which a competitive exchange rate looked to secure export-led growth, while agreement with institutional sources of finance managed external deficits and sterling balance diversification during a period of adjustment. The real significance of the crisis was the recognition that something finally had to be done about the sterling overhang, which took priority in the British assessment of the crisis, resulting in a sustained campaign of economic

¹⁵ *Ibid* p271

diplomacy to secure American support for a wider commitment to sterling. Coming to terms with the Fund was accepted as part of achieving this goal, given American reluctance to proceed until this stage had been completed.

1.3 Methodology

To analyse how this was achieved, the thesis examines the role of the British state as the nexus between the national and international; between the domestic socio-political order from which ruling policymakers and bureaucrats ultimately draw power and the transnational relations of states and markets within which they must operate.¹⁶ According to Robert D. Putnam, states play a 'two-level game', managing the demands of domestic pressure groups to pursue favourable policies (faster growth, higher living standards, concessions to labour unions), while at the international level minimising the impact of external foreign developments on their ability to secure domestic objectives. In short, in an interdependent global economy, states attempt to increase their power with which to pursue domestic objectives, while recognising that attainment of these objectives requires engagement with the structures of the global economy.¹⁷

While the stop-go cycle made contemporaries painfully aware that engagement with the structure of the global economy could act as a constraint on growth, it is important to recognise that such economic concepts are themselves determined by political choices. As Ben Clift and Jim Tomlinson note, "what is at play is not an inexorable logic, but socially and politically constructed interpretations of economic phenomena."¹⁸ The position advanced here was that the external constraint on the British economy was ultimately determined by political decisions made regarding

¹⁶ Theda Skopal, "Bringing the State Back In: Strategies of Analysis in Current Research," in Peter B. Evans, Dietrich Rueschemeyer & Theda Skopal [eds.] *Bringing the State Back In* (Cambridge: Cambridge University Press, 1985) p8

¹⁷ Robert D. Putnam "Diplomacy and Domestic Politics: The Logic of Two-Level Games" *International Organization* (1998) Vol. 43 (2) p434

¹⁸ Ben Clift & Jim Tomlinson "Whatever Happened to the Balance of Payments 'Problem'? The Contingent (Re)Construction of British Economic Performance Assessment" *The British Journal of Politics and International Relations* (2008) Vol. 10 (4) pp. 609, 611

the sterling balances and was amenable to negotiation via a process of economic diplomacy.

However, this process of negotiation increasingly involved British leaders in public and embarrassing disagreement over the causes and solutions of Britain's economic problems.

Disagreement over interpretations can be particularly contentious at times of crisis. As Mark Blyth notes, "what constitutes an economic crisis as a crisis is not a self-apparent phenomenon but needs to be narrated and explained."¹⁹ Failure and crisis can be relatively independent of one another, such as the collapse of sterling in 1975/6 supporting different and conflicting narratives of crisis.²⁰ As Colin Hay writes:

the mobilisation of popular perceptions of crisis is crucial in influencing the trajectory imposed upon the state in the post-crisis phase... crisis is not merely a property of a system, it is a lived experience; it is a politically mediated moment of decisive intervention and structural transformation.²¹

The thesis therefore traces how British governments narrated the causes of sterling crises, both to the international community and their own electorates, according to their interpretation that the fundamental cause of crisis was sterling's continued reserve role which required international support. In response, policy makers applied a process of foreign economic policy and diplomacy to secure beneficial reforms and tailored support packages. The thesis aims to reconstruct this process from policy formulation to execution. A useful distinction is made by John Kingdon between the "agenda setting" of the political leadership and "alternative specification" of the civil service.²² In this example, agenda setting was the responsibility of the duumvirate of Prime Minister and Chancellor which decided on the "problems, policies and politics" awaiting opportunity for policy choice: respectively the constraint imposed by the sterling balances, the availability and terms of international support to mitigate this constraint, and the wider political commitments in which

¹⁹ Mark Blyth *Great Transformations Economic Ideas and Institutional Change in the Twentieth Century* (Cambridge: Cambridge University Press, 2002) p10

²⁰ Colin Hay "Crisis and the Structural Transformation of the State: Interrogating the Process of Change" *The British Journal of Politics and International Relations* (1999) Vol. 1 (3) p.324

²¹ *Ibid* p322

²² John Kingdon *Agendas, Alternatives and Public Policies* second edition (London: Pearson, 2013)

resolving the sterling balances was framed, such as defence of Bretton Woods. “Alternative specification” – the production of proposals to meet this agenda was the responsibility of the civil service, primarily the Treasury which had responsibility for questions of long term international monetary reform through which discussions of sterling’s future were mediated.²³ A number of solutions were proposed: blocking the balances entirely; substitution through a new IMF mediated exchange account; funding them (assuming a new long term obligation in return for short term liabilities) via the market or financing them through drawing on medium term support packages to manage diversification. While all these policies were considered viable by the Treasury at one stage or the other, in the last resort only financing packages proved practical in combining both international financial support with Britain’s conceptions of its own interests, resulting in arrangements organised by the BIS in 1968 and 1977.

This process begins with policy formulation, initially within the Treasury in response to the parameters set by the political leadership and subsequently in direct discussion between members of the economic ‘core executive’, namely the Chancellor, his senior Treasury advisors, the Governor of the Bank of England and the Prime Minister himself.²⁴ Once policy has been decided internally it then evolves through a process of interaction with foreign counterparts, both at the highest level (notably as Prime Ministers attempted to leverage their personal relationship with the American President), and at an intra-organisational level, for example meetings of countries’ respective Treasuries or the collective discussions of central bankers organised via the BIS. This is an extended process of “agenda setting” and “alternative specification” as discussions between the heads of state continue to shape the parameters of available policies discussed in a more technical manner at the inter-organisational level. Final execution of policy often involves a further widening of partners,

²³ Robert F. Durant and Paul F. Diehl “Agendas, Alternatives, and Public Policy: Lessons from the U.S. Foreign Policy Arena” (1989) *Journal of Public Policy* Vol.9 (2) pp. 179 - 205

²⁴ R. A. W. Rhodes, ‘From Prime Ministerial Power to Core Executive’. In R. A. W. Rhodes, and P. Dunleavy (Eds.), *Prime Minister, Cabinet and Core Executive*. (London: Macmillan, 1995), 11-37.

notably the IMF and BIS organisations themselves from where the money and administrative capability were sourced.

Gaining insight into this process of policy formulation and execution has been achieved through a thorough investigation of the archival record, supported by secondary sources such as newspaper articles and statistical bulletins, as well as relevant tertiary literature including technical works on economics, international political economy [IPE], and the memoirs and other analyses of the participants directly involved. Given the extensive technical discussions that constitute the bulk of the narrative, interpretation has been drawn primarily from the archival sources which recorded key events and debates as they happened, while subsequent recollections have been used as corroboration and to add insight into the motivation of the most senior actors involved. Data on current account deficits has been taken from contemporary sources, using the Official Financing category which was discontinued in 1985. This allows the thesis to interpret movements as the leading actors did, through the prism of changes in the level of the sterling balances.²⁵ To avoid the problems resulting immediate revisions of data that bedevilled statistical releases, data for any given year has been taken from a release 2 years later.

The majority of the archival research has been drawn from the National Archives [TNA], focusing on memoranda, reports and records of conversations between the key participants released under the thirty-year rule. In one case it was necessary to make a Freedom of Information request in order to obtain a Treasury file detailing debates between the PM, Chancellor, Governor and Treasury over the retirement of the IMF standby and BIS facility in 1977/78.

Given the process of policy formulation and execution that the thesis investigates, the major focus of archival research has been on the Treasury's Overseas Finance Department, which provided the bulk of proposals for policy that were subsequently developed with and used by the Chancellor and PM in their discussions with international interlocutors. These files include both internal memoranda

²⁵ Thirlwall and Gibson *Balance of Payments Theory* p11

shared between Treasury officials as they discussed proposed responses to the political objectives emanating from their political leaders but also records of conversations with the Chancellor, Prime Minister as well as the Treasury's own foreign counterparts. As Prime Ministers during this period tended to act as their own foreign secretary when dealing with economic matters, extensive attention has also been paid to files from the Office of the Prime Minister. These include the personal appeals the PM made to foreign counterparts in attempts to mitigate sterling's external constraint (and subsequent replies), as well as analysis and advice from the PM's own economic advisors. These latter documents are significant, not because of the influence they had on policy but rather the opposite; as the PM agreed with the Treasury view on most major proposals regarding reform, they demonstrate the extent to which Treasury opinion dominated policy formation.

Although usually the duumvirate of the PM and Chancellor decided foreign economic strategy between them, at times of great external crisis they were forced to defend and seek support for their strategy from the wider Cabinet. As such, Cabinet files have been used for these periods, most notably during negotiations with the IMF in 1976 where there existed dramatic disagreement between this duumvirate and other ministers, particularly those calling for an Alternative Economic Strategy [AES]. As the Treasury dominated policy formulation, the Bank of England's role in this process lay more in execution, particularly at the central banker only meetings of the BIS. However, joint Bank-Treasury submissions on sterling have been recorded in the Treasury files, as have personal interventions of the Governor of the Bank of England, either made to the Chancellor or the Prime Minister. Taken collectively these interactions give an overall impression of the relative disagreements between the Treasury and the Bank's views (notably in 1976 when the Bank's interpretation of the crisis was much closer to the Americans than Callaghan's) and again serve to demonstrate that policy formulation was generally decided in favour of the Treasury's interpretation.

The primary focus of the thesis is on British policy formulation but viewed through the interaction it had with foreign institutions and governments, of which the most notable was the American government. While it was not possible to visit US archives directly due to budget and timing constraints, resources available digitally via the Foreign Relations of the United States [FRUS] and minutes of the Federal Reserve have proved useful in understanding the international context facing the British leadership as they advanced their strategy for sterling. They specifically capture the American objectives for international monetary reform, as well as debates internally between the US Treasury, State Department, Federal Reserve and Office of the President over how to respond both to crises afflicting Bretton Woods in general and sterling in particular. Most significantly they record key interventions from British Prime Ministers, so we are able to gain insight into how these were received and how the American response was developed. While the FRUS records are not complete and therefore analysis of them is reliant on the decisions of the editors over what to include and what to omit, they have proved a useful source in understanding the international context in which British strategies for resolving sterling operated.

1.4 Structure of the Thesis

The thesis is divided into seven main chapters. Chapter two provides a theoretical overview of the nature of the external constraint imposed by sterling's reserve role. It discusses the combination of power and purpose inherent in the principles of embedded liberalism, and how Britain's commitment to this shaped its attitudes towards resolving sterling's international status. It then analyses the external constraint faced by sterling as a result of this commitment through the prism of adjustment, liquidity and confidence, the major topics of reform discussions. Chapter three reviews the literature dealing with the external constraint. While most analyses have been critical of what they see as attempts to prioritise sterling's international use over domestic investment, in hindsight we can see the basis of contemporary criticism changes in response to shifts in the international monetary system, suggesting the commitment to this played an important role. The

chapter provides a detailed overview of the work of Catherine Schenk, whose revisionist interpretation of sterling's retirement the thesis aims to extend.

Chapters three, four and five contains the bulk of the analysis. Chapter three examines Britain's struggle back to surplus from November 1967 to May 1970 amid the turmoil that sterling's devaluation unleashed on the Bretton Woods system. This was a period of considerable stress for Britain's integration into the global economy. A series of exchange crises involving the dollar, franc and Deutschmark [DM] destabilised sterling, while expectations of a surplus were repeatedly disappointed into mid-1969. Devaluation had made the sterling balance holders nervous, while the cover of official reserves was lower than later during the IMF crisis. Contingency plans were made should reserves run out to float sterling and block the sterling balances, inviting retaliation against British investments abroad.²⁶ Commitment to the new parity meant adjustment was sought in other areas. Labour's policy response to devaluation involved bigger increases in taxes and reductions in spending than occurred in 1976. Britain also resolved to live within its means as a medium sized power, accelerating the retreat from worldwide military commitments.

These policies were enacted not to defend sterling's international role but the wider Bretton Woods system. Despite devaluation, Britain remained committed to the system, sharing a contemporary fear that an anticipated collapse heralded the return to the economic and political conflict of the inter war years. The systemic importance of sterling to Bretton Woods, combined with the commitment of the American leadership under President Johnson to reform, provided the British with leverage to secure international support for sterling.²⁷ While this support did not come attached with conditionality regarding domestic policy (which was not required given Labour's policies), externally it was orientated towards preservation of Bretton Woods. In particular, the 1968 BIS Second Group Arrangement managing devaluation of the sterling balance holders offered

²⁶ Oliver & Hamilton "Downhill from Devaluation" *passim*

²⁷ See Newton "Sterling Bretton Woods and Social Democracy 1968 – 1970" pp.427-429

expensive inducements in the form of exchange rate guarantees and high interest rates, facilitating a renewed accumulation in the balances. Hopes were instead placed on the process of international monetary reform, in which a general solution to reserve currencies would resolve the sterling overhang. Despite progress on Special Drawing Rights [SDRs] as a supplement to reserves, the level of compromise to secure activation undermined their attractiveness and hence ability to replace sterling.²⁸

Chapter five examines the British response to the collapse of Bretton Woods following Richard Nixon's decision to unilaterally break to gold-dollar link that was a foundation of the system. Despite being provoked by American complaints over adjustment (namely the supposed inability of the dollar to devalue under Bretton Woods), the major source of contention quickly became liquidity, as the American policy of 'benign neglect' flooded the world with unconvertible dollars, forcing surplus economies to either acquiesce in American deficits by accumulating them or by revaluing their currencies upwards.²⁹

As sterling was stable during this period due to the combination of Britain's external surplus and the 1968 BIS deal, the short-term impact of the Nixon Shock was limited. The major development was the breakdown in the commitment to pegged exchange rates, a loosening of the external constraint that allowed Heath to float sterling in 1972 rather than restrain his domestic expansion. Aware that this would soon re-open the question of the sterling overhang and faced with American unilateralism following the Nixon Shock, Heath looked to Europe for a solution.³⁰ Following agreement of British accession to the EEC in 1972, Heath attempted to accelerate the timetable for European monetary union in which members' assets and liabilities would be pooled. However, any prospective common European monetary policy effectively aimed to recreate Bretton Woods, with

²⁸ Harold James *International Monetary Cooperation Since Bretton Woods* (Oxford: Oxford University Press, 1996) pp. 183-190

²⁹ James *International Monetary Cooperation* pp.228 -229; Barry Eichengreen *Globalizing Capital: A History of the International Monetary System* (Woodstock: Princeton University Press, 2008) p117

³⁰Eichengreen *Globalizing Capital* pp.134-140

fixed exchange rates and limited, conditional support for weak currencies. Heath was ultimately unwilling to re-impose any significant form of external constraint on the British economy and so his demands for unconditional and unlimited support for sterling as the price for joining precluded participation.³¹ As such, there was no restraint on expansion of the current account deficit just when the external environment turned against sterling once more following the 1973 OPEC oil shock.

Chapter six deals with aftermath of the OPEC oil shock and the descent to IMF negotiations in 1976. The resulting inflation undermined any attempt to restore Bretton Woods and by 1976 America was able to secure its objective of a floating, fiat, dollar based standard. This permitted sterling crises to be much more effectively contained than in the past. A weak Labour government sought to buy domestic peace through high government spending, encouraging newly enriched oil producers to deposit their funds in sterling, facilitating a further build up in the balances which was concentrated in a relatively small number of holders.³² Internationally, Labour was isolated in its focus on the unemployment impact of the oil shock rather than inflation and increasingly at odds with an American administration which was diverging ideologically in its diagnosis of sterling's problems and frustrated that Britain's reliance on oil producers' funds to defer adjustment was undermining calls for a common front to force the price back down.³³

Market confidence turned against in Labour in 1975 in response to an unprecedented current account deficit and the suspicion that the Bank of England was attempting to engineer a devaluation. Despite making sizable changes to public spending in 1975, this was not enough to restore market confidence in sterling, which instead looked for the IMF's 'seal of approval' that Labour's domestic policies were appropriate. This required a reorientation of British economic diplomacy back towards the US as the major source of financial support and institutional influence. However, the US Treasury pressed President Gerald Ford to take a tough line with British requests

³¹ Kenneth Dyson and Kevin Featherstone *The Road to Maastricht Negotiating Economic and Monetary Union* (Oxford: Oxford University Press, 2003) p538

³² Newton *The Reinvention of Britain* pp. 98-104

³³ Schenk *The Decline of Sterling* p375

for support, using IMF conditionality to restore British policy to what it perceived as a more sustainable footing.

In response, the British government under James Callaghan was successful in re-framing the crisis as one revolving around the sterling balances and securing additional support aimed at resolving sterling's international role. Callaghan was able to leverage acceptance of IMF conditionality to secure American support for an additional facility for the sterling balances while also facing down opposition within his party in favour of AES that would require a level of protectionism unprecedented since post-war reconstruction. For their part, the newly flexible international monetary system allowed America to finance support for sterling without regard to pressure on its gold supply. Ford offered his backing for a separate facility for the sterling balances (following agreement with the IMF) in return for a commitment by Callaghan to prevent any future accumulations. Despite Callaghan's personal disappointment on the size of the facility and timing of its announcement, the BIS Third Group Arrangement, operating in conjunction with the IMF deal resulted in an overwhelming market endorsement of sterling, the first time Britain had combined tangible measures to reduce the balances with a political commitment to do so. The removal of the sterling overhang resolved the most significant constraint on British foreign economic policy.

In chapter seven I offer my conclusions, arguing that the experience of this period suggests the true determinant of states' ability to pursue autonomous policies lies in the strength of their political relationships with sources of financial support and the success with which they contest narratives of crises.

Chapter 2

Constituting the External Constraint

The purpose of this chapter is to demonstrate that the repeated sterling crises experienced by Britain between 1967 and 1977 were not determined solely by economic criteria but the shifting material and ideological bases of the global economy. The renewed accumulation of sterling balances following devaluation is explained by Britain's commitment to the principles of embedded liberalism that had characterised post-war cooperation in monetary relations. As part of the compromise of embedded liberalism, Britain looked to secure autonomy in domestic policy consistent with stability in external exchange. Sterling balance accumulation was acquiesced to in the interest of stabilising the international monetary system and maintaining output in the face of the external crises. As part of this commitment, Britain expected to be able to negotiate the external constraint imposed by adherence to the system's provision of adjustment, liquidity and confidence through a process of general reform and tailored support packages for sterling.

This process was undermined by ideational change within the US government, as frustration grew over the constraint imposed by the international monetary system on America's ability to secure its wider foreign policy objectives. From 1971 ideological change in the US Treasury saw the adoption of neoliberal principles over the previous commitment to embedded liberalism, accommodating the expansion of global capital markets with a more flexible, fiat-dollar based standard that more easily financed their aid, trade and security commitments. These material and ideational changes prompted growing divergence from the British in their interpretation of sterling crises (both causes

of and solutions to), while also allowing them to isolate the systematic impact of these crises more effectively than under Bretton Woods. In response to both the changed international monetary system and basis of the relationship with the crucial American source of support and influence, Britain prioritised resolution of the sterling overhang during the 1976 IMF crisis, negotiating a final support package in return for coming to agreement with the Fund over domestic policy and a renewed commitment to prevent any future accumulations.

The chapter first develops a constructivist approach to international monetary relations to understand the nature of Britain's commitments to external stability and domestic autonomy. It then analyses the constraints imposed by sterling's reserve role and its adherence to systemic provision of adjustment, liquidity and confidence that these commitments implied.

2.1: The Construction of Balance of Payments Crises

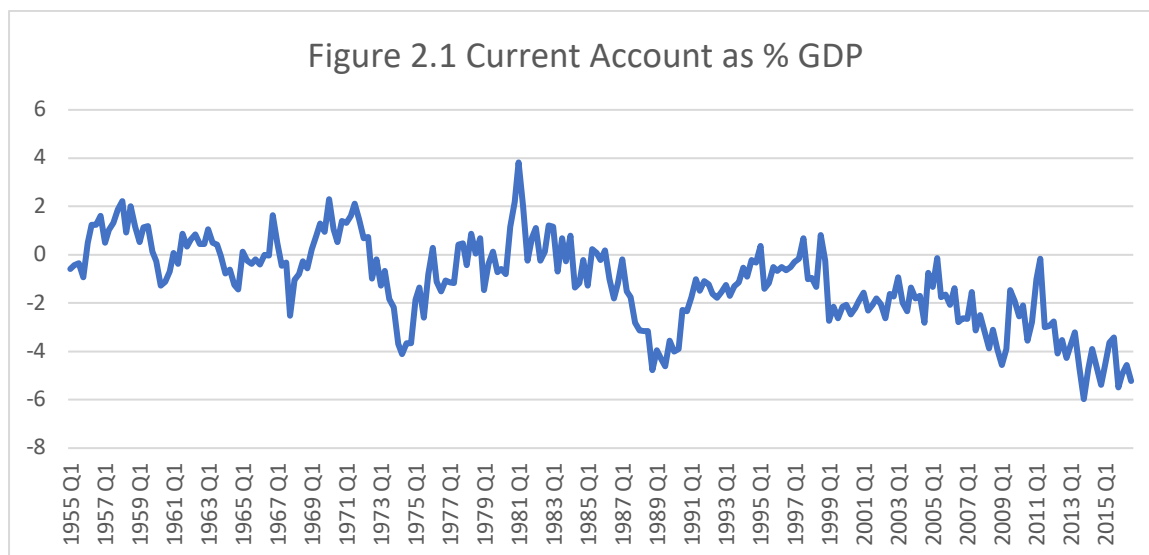
Throughout the 1960s and 1970s, the perceived weakness of Britain's balance of payments was held to impose a significant constraint on the growth of the British economy, particularly when compared with the stronger growth of surplus economies like West Germany and Japan.¹ Officially, the post-war objective of maintaining demand in the economy meant concern focused on the current account trade in goods and services. According to this analysis, current account deficits stemming from the low global income elasticity of demand for British exports, ultimately constrained the growth of the British economy.²

This analysis however only explains part of the external constraint Britain faced. As Figure 2.1 demonstrates, since the 1980s Britain has persistently run deficits far exceeding those responsible

¹ As its simplest, the balance of payments is an accounting identity which, by definition, must always be in balance. Taking the totality of an economy's exchange with the rest of the world in goods, services and financial transactions over a period of time, all credits are matched by corresponding debit. The term balance of payments deficit is technically a misnomer since as an accounting identity the balance of payments must by definition always balance through an equivalence of payments and receipts. see Peter Jay, "The American Way of Calculation" *The Times* 24 July 1969; *Economic Report of the President* (Washington D.C: US Government., 1968), pp. 167 – 169; Eric Chalmers *International Interest Rate War* (London: Macmillan, 1972) pp167 - 168

² A. P. Thirlwall & Heather D. Gibson *Balance of Payments Theory* p136

for the repeated sterling crises in the 1960s and '70s without generating anywhere near the concern among policymakers and markets. This indicates the extent to which balance of payments deficits constitutes a problem is dependent on material and ideational changes in both the global economy and Britain's place within it.³



Source: Office of National Statistics. Current Account Balance, Seasonally Adjusted [HBOP], Gross Domestic Product at Market Prices, Seasonally Adjusted [YBHA], Accessed Online

Material accounts of international monetary relations, both Marxist and realist, argue that in a system in which governments' pursuit of domestic objectives requires private resources, there exists a structural dependency of the state on capital which constrains policy choice.⁴ The growth in global capital flows that accelerated with the end of Bretton Woods has established a conflict between states and supranational markets, limiting the ability of discretionary fiscal and monetary policy to secure national objectives.⁵ For left-wing parties, this raises the dilemma that even with limited capital mobility, policies of redistribution can provoke capital flight, requiring them to moderate

³ Clift & Tomlinson "Whatever Happened to the Balance of Payments 'Problem'" p610

⁴ Adam Przeworski and Michael Wallerstein, "Structural Dependence of the State on Capital" *American Political Science Review* (1988) Vol 82 (1) p.13

⁵ Marice Obstfeld and Alan M. Taylor *Global Capital Markets Integration, Crisis and Growth* (Cambridge: Cambridge University Press, 2004) p12

policies before they assume power in order to reassure markets.⁶ Control of inflation, which preserves the value of currencies held by foreign exchange dealers, takes priority for states dependent on global capital markets rather than institutional sources of finance such as the IMF.⁷

While according to the terms of the macro-economic trilemma, a floating exchange rate can insulate monetary policy from capital flows, state managers have proved reluctant to assume a purely market determined rate that might undermine other macro-economic goals, including inflation.⁸

While not ignoring the role of material shifts in economic relations, social constructivist approaches to political economy highlight the extent to which problems and outcomes are constituted through the causal power of ideas.⁹ This relative autonomy of the ideational creates space for actors to differ in how they perceive, define and interpret a set of material conditions as problems to be solved.¹⁰

Markets are embedded within wider framework of political and social relations, dependent on the state for their effective functioning.¹¹ As such, policy makers do not interpret their economies in purely material terms but according to interpretations based on their own notions of social purpose, which combine to shape economic outcomes. According to Abdelal et.al:

Economic activity and international interdependence tend to be treated not as ends in themselves or as brute material constraints, but rather as a mode of acting within the world according to different constituted identities.¹²

⁶ Mark Wickham-Jones "Anticipating Social Democracy, Preempting Anticipations: Economic Policy-Making in the British Labor Party, 1987-1992" *Politics and Society* (1995) Vol. 23 (4) pp. 465-467

⁷ Jim Buller and Matthew Flinders, "The Domestic Origins of Depoliticisation in the Area of British Economic Policy," *The British Journal of Politics and International Relations* (2005) Vol. 7 (4) p528

⁸ Otfeld and Taylor, *Global Capital Markets* pp. 29-31

⁹ Clift & Tomlinson "Whatever Happened to the Balance of Payments 'Problem'?" p609

¹⁰ Ben Clift *Comparative Political Economy States Markets and Global Capitalism* (Basingstoke: Palgrave, 2014) p145

¹¹ Mark Blyth *Great Transformations*: pp 3 - 4

¹² Rawi Abdelal, Mark Blyth, & Craig Parsons, "Introduction: Constructing the International Economy" in Rawi Abdelal, Mark Blyth, & Craig Parsons [eds.], *Constructing the International Economy* (Ithaca: Cornell University Press, 2010) p9

As Jim Tomlinson argues therefore, economic problems should be seen as “neither ‘natural’ nor as self-evident, but as the product.... of a particular conjecture of economic and political events.”¹³

Throughout the post-war period, official focus on the current account obscured the extent to which capital export in the form of military expenditure, official aid and private overseas investment were significant elements of Britain’s external deficits. This expenditure was instead taken as given, in line with Britain’s worldwide military, financial and trading interests as part of its identity as a world power. As a result, achieving the current account surpluses required to pay for it assumed a greater significance.¹⁴ Similarly, while sterling’s reserve role was widely held to act as a constraint on domestic policy, requiring high interest rates and other inducements to prevent diversification, the accumulation of these balances from devaluation and into 1976 suggests they continued to play a role within the framework of a wider conception of Britain’s interests and responsibilities.

To understand why requires analysis of Britain’s integration into the open, liberal, multilateral trading order that had been born at the Bretton Woods conference in 1944, enshrined in institutions like the International Monetary Fund [IMF], World Bank and the General Agreement on Tariffs and Trade [GATT]. Together, these agreements and institutions constituted a regime, best understood as the “principles, norms, rules and decision-making” around which actors’ expectations converged during the post-war period, conditioning understanding of their rights and responsibilities, while also fostering cooperation in international monetary relations.¹⁵ This commitment to multilateralism stood in stark contrast to the breakdown of the global economy during the Great Depression when, according to an influential 1944 League of Nations report, protectionism, bilateralism and beggar-thy-neighbour currency depreciations had destabilised global politics and eventually led to war.¹⁶

¹³ Jim Tomlinson “Balanced Accounts? Constructing the Balance of Payments Problem in Post-war Britain” *The English Historical Review* (2009) Vol. CXXIV (509) p865

¹⁴ *Ibid.* p883

¹⁵ Stephen D. Krasner “Structural Causes and Regime Consequences: Regimes as Intervening Variables,” in Stephen D. Krasner [ed.] *International Regimes* (Ithaca: Cornell University Press, 1983) p1; Donald J. Puchala and Raymond F. Hopkins “International Regimes: Lessons from Inductive Analysis,” in Krasner [ed.] *International Regimes* p62-63

¹⁶ Eichengreen *Globalizing Capital* pp.43-44, 61

In an influential article, John Ruggie argued that the system established at Bretton Woods fused both power and purpose to form a regime based on the principles of “embedded liberalism.” The experience of the inter-war period, including the development of Keynesian economics, informed the design of Bretton Woods as a framework that would facilitate governments to autonomously pursue welfare maximising expansionary domestic policies without destabilising an integrated, liberal global economy. According to Ruggie:

This was the essence of the embedded liberalism compromise: unlike the economic nationalism of the thirties, it would be multilateral in character; unlike the liberalism of the gold standard and free trade, its multilateralism would be predicated upon domestic interventionism.¹⁷

The intersubjective, normative commitment to the principles of embedded liberalism constituted a powerful reason to defend and reform the institutions of Bretton Woods. In turn, this generated a “grammar” used to determine the “interpretation of the appropriateness of acts.”¹⁸ For example, capital controls were permitted, since based on the understanding of the founders, short term capital flows could destabilise expansionary policies. This approach was vindicated in the twenty-five years following the Bretton Woods conference. The great post-war economic boom in which output and living standards grew at unprecedented rates was driven by trade in manufactured goods between developed economies.¹⁹ While the precise contribution of the Bretton Woods institutions is a subject of debate, the period 1945-71 was characterised by macroeconomic stability in exchange rates, a distinct lack of major financial crises and sustained growth in trade and investment.²⁰

As a result, the constraint imposed by the sterling overhang was determined by the priority Britain attached to stability in international monetary relations as providing the framework for domestic

¹⁷ John Ruggie “International Regimes, Transactions and Change: Embedded Liberalism in the Postwar Economic Order” *International Organisation* (1982) Vol. 36 (2) p393

¹⁸ Clift & Tomlinson “Whatever Happened to the Balance of Payments ‘Problem’?” p611

¹⁹ George Kenwood and Alan Loughheed *The Growth of the International Economy 1820-2000* 4th ed. (London: Routledge, 1992) p286

²⁰ Michael D. Bordo “The Bretton Woods International Monetary System: A Historical Overview” in Michael D. Bordo and Barry Eichengreen [eds.] *A Retrospective on the Bretton Woods System: Lessons for International Monetary Reform* (Chicago: University of Chicago Press, 1993) p27

policy autonomy as well as the stable trading and investing relationships upon which prosperity was held to depend.²¹ The attempt to defend and reform Bretton Woods following devaluation required stabilisation of the balances with new inducements to holders that proved so attractive they facilitated a fresh accumulation following agreement of the 1968 Second Group Arrangement. Following breakdown of the Bretton Woods system and particularly in response to the consequences of the 1973 Organisation of Petroleum Exporting Countries [OPEC], the balances were used to maintain output and facilitate more expansionary domestic policies than would otherwise have been possible.²²

In return, Britain expected that the shared normative commitment to the principles of embedded liberalism would provide financial support needed to finance diversification and fund deficits as it retreated from a global role. What has been called the “ultimate constraint on growth” for Britain was therefore its ability to borrow, which shifted with the amount of liquidity available in the global economy and the willingness of lenders, public or private, to extend finance to Britain.²³ As such extending these source of support proved the major objective of economic diplomacy for most of the period under consideration. Only in response to the changed ideological circumstances of 1975/76 did resolution of the sterling overhang finally take priority, as the culmination of general reform process in line with the new neo-liberal focus of the US Treasury failed to resolve sterling’s international role, requiring a more direct approach.

²¹ See for example, Roy Jenkins speech ref.; Hansard HC Deb 25 June 1968 Vol. 767 cols. 222-223

²² David Andrews makes the distinction between the Bretton Woods *system* of pegged exchange rates and dollar-gold convertibility, the normative framework of the Bretton Woods *order*, namely that states should cooperate in monetary relations to “enjoy maximum degree of national economic policy autonomy within an international framework conducive to a massive expansion of trade,” which continued beyond 1971, see David M Andrews “Bretton Woods System and Order” in David M. Andrews [ed.] *Orderly Change: International Monetary Relations Since Bretton Woods* (Ithaca: Cornell University Press, 2008) pp 10-11

²³ Thirlwall & Gibson *Balance of Payments Theory* p7

2.2: Ideational Change and Conflict in Monetary Relations

The design of Bretton Woods was never comprehensive enough to prevent disagreement over its future direction. As Kathleen Thelen and Sven Steinmo argue, while actors must adapt to accommodate institutional change:

“strategic manoeuvring by political actors and conflict among them within institutional constraints can influence the institutional parameters within which their interactions occur.”²⁴

While this offered opportunities for Britain to renegotiate the terms on which it maintained the sterling balances, ideological conflict over the scope of reform also moderated the terms and availability of financial support.

The failure of the Bretton Woods system of pegged exchange rates to cope with return of inflation and global capital flows, combined with the novel experience of stagflation following the OPEC shock to generate renewed interest in neoliberal economic ideas that advocated control of the money supply and public spending to bring down inflation.²⁵ Analyses of the causal power of ideas hold that the failure of Keynesianism to solve these new economic challenges spurred a process of policy innovation and a re-conception of the role of the state, prioritising control of inflation over the post-war focus on maintaining demand and unemployment.²⁶

This process has been analysed domestically in Britain as a process of state learning, in which the response to the oil shock involved innovations in control of the money supply and public expenditure. These were adopted reluctantly by Labour before a more enthusiastic acceptance by Thatcher’s Conservatives in 1979.²⁷ Internationally however this process began at the beginning of

²⁴ Kathleen Thelen and Sven Steinmo “Historical Institutionalism in Comparative Politics” in Sven Steinmo, Kathleen Thelen and Frank Longstreth [eds.] *Structuring Politics Historical Institutionalism in Comparative Analysis* (Cambridge: Cambridge University Press, 2008) pp.16-17

²⁵ Blyth *Great Transformations* p10

²⁶ Kathleen R. McNamara, *The Currency of Ideas: Monetary Politics in the European Union* (Ithaca: Cornell University Press, 1998) p6

²⁷ Peter Hall, “Policy Paradigms, Social Learning and the State The Case of Economic Policymaking in Britain” *Comparative Politics* (1993) Vol. 25 (3) p279

the 1970s in response to growing American frustration with the entire post-war economic and security architecture. This included concerns that the *n-1* pattern of exchange rates under Bretton Woods prevented the dollar from adjusting (see below) but extended to frustration over trade discrimination by the now reconstructed western European economies and complaints that these countries were not pulling their weight in sharing the burden of defence (exacerbated by Britain's withdrawal 'east of Suez' in 1971).²⁸

The initial attempt of the Nixon Shock was to secure a broad reform to monetary, trade and defence relations. While John Connally was Secretary of the Treasury, neo-liberal ideas were used operationally, such as the (planned) temporary use of floating exchange rates before re-establishing parities at the Smithsonian Agreement in December 1971. The almost immediate breakdown of the Smithsonian agreement as well as the differential rates of inflation unleashed by the 1973 OPEC oil shock allowed Connally's successors George Schultz (a university friend of Milton Friedman) and William Simon to pursue a more radical agenda. This involved the establishment of floating exchange rates as the formal method of adjustment, the demonetisation of gold, the removal of American capital controls and the encouragement of private capital markets to intermediate flows following the OPEC shock. Collectively these changes allowed America's global interests to be financed much more cheaply.²⁹

The conflict resulting from this ideological change in the US government was exacerbated by the response to the 1973 oil crisis, in which they were reluctant to create new institutional sources of financing to maintain oil deficits for fear of entrenching the higher price. Instead they preferred that countries adjust to the new circumstances, which proved easier for America due to its lower dependency on foreign imports. This implied a significant change in their perception of the sterling balance problem than in 1967-1970. As Mark Blyth argues:

²⁸ Francis J. Gavin *Gold, Dollars and Power: The Politics of International Monetary Relations, 1958-1971* (Chapel Hill: University of North Carolina Press, 2004) p194

²⁹ Eichengreen *Globalizing Capital* p137

Since structures do not come with an instruction sheet, economic ideas make such an institutional resolution possible by providing the authorities diagnosis as to what a crisis *actually is* and when a given situation *actually constitutes a crisis*. They diagnose 'what has gone wrong' and thus 'what is to be done'³⁰

According to the neo-liberal analysis of the US Treasury, the sterling crisis that erupted in 1975 resulted from over-expansionary economic policies and too conciliatory an approach to trade unions resulting in a rate of inflation that was much higher than in comparable countries. Their perception of the crisis was primarily interpreted through the prism of inappropriate domestic policy and their solutions accordingly looked to retrenchment in government expenditure and greater control of the money supply in line with the prescriptions of neo-liberal economic thought then in the ascendancy. A harder line with the British over IMF conditionality was permissible due to the more flexible, fiat dollar standard that allowed sterling crises to be more effectively contained than under Bretton Woods.

In contrast, the official British point of view determined by Prime Minister Jim Callaghan was that the fundamental cause of the crisis was sterling's continued reserve role, and therefore any solution that did not take in the sterling balances would fail to resolve the problem. While Callaghan's attempt to narrate the crisis as stemming from the sterling balances finally prioritised resolving sterling's reserve role, it also resulted in contentious debates with the US Treasury. According to the American analysis, merely coming to terms with the Fund's proscriptions for domestic policy would resolve the so-called problem of the sterling balances. This objection forced Callaghan to first come to terms with the Fund, however his public and private campaign to secure additional support for sterling raised expectations that such a facility would be forthcoming. Although considering the economic case weak, the US Treasury concluded that this meant it could be financed cheaply and eventually acquiesced in return for Callaghan making a renewed commitment to prevent any future accumulation of the sterling balances following the conclusion of IMF negotiations. Despite differing

³⁰ Mark Blyth, *Great Transformations* p10

interpretation of the nature of the crisis (and prospective solutions) according to their respective economic ideology (neoliberal vs embedded liberal), Callaghan's economic diplomacy was successful in securing a final support package for sterling, ending its reserve role.

2.3: Sterling as an International Currency

The resolution of the sterling overhang marked the end of sterling's role as an international currency. Prior to this, Britain had maintained its international use in the interest of stabilising the wider international monetary system or prioritising domestic expansion. Instead the process of international monetary reform was expected to provide some resolution of the constraint imposed by the sterling overhang, through Anglo-American cooperation based on their shared identity as issuers of international currencies. Sterling's continued international use however became increasingly contentious through its impact on the domestic economy.

According to the field of International Political Economy, international use of a currency stems from the political and economic foundations of the issuing state (such as its share of global output and trade); the development of its financial capital markets; and political and military ties which encourage foreign use while reassuring domestic investors of the security of their investments.³¹

From this international use flow both benefits and risks, of which the most relevant is the extent to which international use provides "macroeconomic flexibility," increasing autonomy in domestic policy.

For 'strong' currencies, international use enhances macroeconomic flexibility, by enabling purchases of foreign goods and services abroad in domestic currency – what the French termed the 'exorbitant privilege' of the dollar in the post-war world allowing US companies to buy up European counterparts cheaply.³² Conversely a 'weak' currency faces what might be termed the "exorbitant

³¹ Benjamin Cohen *Currency Power Understanding Monetary Rivalry* (Princeton: Princeton University Press, 2015) pp.121-123

³² Gavin Gold, *Dollars and Power* pp.202-203

duty." Excessive accumulation of liquid foreign liabilities in the form of mobile debt such as the sterling balances require higher interest rates to induce holders not to diversify.³³

Despite the contemporary assumption that as reserve currencies the dollar and sterling faced similar problems, subsequent experience demonstrated this was not the case. Despite concerns over the future of dollar, the lack of a credible alternative meant its future was secure as it has continued to form the basis of international payments until the present day. For sterling however, the real threat of diversification (including into dollars), marked it as a weak currency. Its international role therefore served as a constraint on domestic macroeconomic autonomy, as the need to maintain confidence among foreign holders led to higher interest rates and other inducements that limited domestic credit, investment and hence growth.

One dimension of difference between sterling and the dollar was the time they had been used internationally. According to Chey, the benefits accruing to the nation issuing an international currency, such as macroeconomic flexibility, is strongest in the earliest phase of its use. Over time however, foreign holdings of the currency accumulate to the point where they constitute a constraint of the operation of monetary policy, requiring higher interest rates or a depletion of the nation's own reserves to manage diversification.³⁴ Thus while renewed accumulation could provide a short-term source of macroeconomic flexibility for Britain (as resulted following oil producers' deposit of earnings into sterling between 1974 and mid 1975), ultimately this exacerbated the problem once market confidence turned against sterling.

Another major difference between the two was their power in the international economy. Despite the contemporary view that the travails of Vietnam and challenge of OPEC meant that US power was in decline (with consequences for stability of the international economy), in hindsight we can see this was an exaggeration. The US remained a superpower, dominating the institutions of the global

³³ Cohen *Currency Power* pp.24-45

³⁴ Hyoung-Kyu Chey "Theories of International Currencies and the Future of the World Monetary Order" *International Studies Review* (2012) Vol.14 (1) pp57-58

economy while the dollar continued to serve as the world's premier currency.³⁵ In contrast, by 1967 the foundations of sterling's international power – the financial, political and military links between Britain and the Sterling Area – had clearly waned.

Collectively therefore, the changing material bases of sterling's international role, in terms of the duration of its use and politico-economic power of the British state meant the commitment to its continued use acted as a constraint.

The International System – Adjustment, Liquidity and Confidence

The maintenance of sterling's international role was tied to Britain's commitment to the principles of embedded liberalism which in turn subjected sterling to the international monetary system's provisions of adjustment, liquidity and confidence. Although the operation of these were widely held to act as additional constraints on the British economy, it was expected that ongoing process of reform would alleviate both them as well as resolve sterling's reserve role. It was only with the culmination of the reform process in 1976 with the establishment of a fiat, floating dollar standard that left sterling's international status unresolved that Britain prioritised ending it via a tailored support package.

Prior to the 1971 Nixon Shock, Anglo-American cooperation had formed the basis of British strategies for reform, based on the assumption that they had shared interests as issuers of international currencies. Subsequent experience proved this to be a mirage. For the Americans, the major concern was with adjustment. The *n-1* pattern of exchange rate parities in which currencies were expressed in relation to the dollar supposedly precluded the dollar's adjustment. Instead, the Americans relied on changes in other currencies to improve the competitive position of the dollar. The reluctance of surplus economies to appreciate their currencies, combined with the sterilisation of the resulting capital inflow in order to prevent expansion of domestic spending, both of which

³⁵ Benjamin Cohen *International Political Economy An Intellectual History* (Princeton: Princeton University Press, 2008) pp.67-68, 76

would have resulted in increased foreign demand for American goods, prompted the search for more dramatic solutions, culminating in the Nixon Shock.³⁶

Adjustment under Bretton Woods was also a source of constraint for sterling. While the founders of the system had envisaged regular changes to the exchange rate pegs, the case of ‘fundamental disequilibrium’ in which this was to happen was never clearly enough defined to be operational.³⁷

The system suffered from a devaluation bias, in which countries running deficits faced real pressure to either devalue or deflate before resources ran out, while the sanctions against surplus countries appeared only “moral and persuasive.”³⁸ Changes in exchange rate parities were infrequent; weak currencies associated devaluation with defeat, while countries running surpluses sought to preserve their competitive advantage by resisting appreciation. In the time between fundamental disequilibrium first emerging and adjustment, imbalances built up in the system which made the eventual adjustment even more painful.³⁹ According to Samuel Brittan, the Bretton Woods compromise gave

Neither the stability of really fixed rates, nor the independence of internal policy of flexible systems. It does on the other hand manufacture balance of payments problems and currency crises on a scale peculiarly its own.⁴⁰

The constraint imposed by the need to maintain Bretton Woods’ exchange rate parity was at its most contentious during Harold Wilson’s first Labour government between 1964-70. In opposition, Wilson had promised to re-forge the British economy in the “white heat” of scientific change driven by the establishment of a National Plan for industry. However, the need to defend sterling against successive exchange crises (beginning almost immediately upon Wilson arriving in power), resulted

³⁶ S.W. Black “International Money and International Monetary Arrangements” in Ronald W. Jones & Peter B. Kenen [eds.] *Handbook of International Economics Vol.2 International Monetary Economics and Finance* (Amsterdam: North Holland, 2006) p221

³⁷ W. M. Scammell *International Monetary Policy Bretton Woods & After* (London: Macmillan Press, 1977) p84

³⁸ *Ibid* p42

³⁹ Gianni Toniolo *Central Bank Cooperation at the Bank for International Settlements* (Cambridge: Cambridge University Press, 2007) p431

⁴⁰ Samuel Brittan *The Price of Economic Freedom A Guide to Flexible Rates* (London: Macmillan, 1970) p9

instead in a series of measures intended to defend the rate by restraining growth of both public and private credit (thus restricting imports), while moving resources into exports. According to the traditional interpretation, Wilson's decision to rule out devaluation until 1967 prioritised defence of the sterling parity and international monetary system over the demands of the domestic economy.⁴¹

While contemporaries and historians have both criticised Wilson for not loosening the adjustment constraint by devaluing sooner or even floating the currency, subsequent experience suggests this was no panacea. Devaluation in 1967 was followed by years of further restraint on spending in order to secure an external surplus. When the currency was floated in 1972 in order to prevent an expansion being derailed by capital outflow, the result was an unprecedented current account deficit. While the sterling balances were temporarily stabilised due to the terms of the 1968 Basle deal, Edward Heath's prioritisation of domestic expansion over commitments that might reduce the sterling balances meant these continued to threaten stability.

Given the continued existence of the sterling balances, Britain's major concern in international reform was the systematic provision of liquidity, notably its dependence on foreign currencies including sterling. Prior to the Nixon Shock, the great post-war boom in trade raised fears that there was insufficient liquidity in the system to support future growth. According to the eponymous Triffin paradox formulated in 1960, the inelastic supply of gold meant the dollar provided the main source of liquidity growth under Bretton Woods. As global trade expanded faster than output, the system required an expanding supply of dollars to finance it. However these dollars undermined confidence in the system as foreign holders of dollars came to doubt that the US would be able to meet its obligation to supply gold at the fixed price of \$35 per ounce.⁴² A process of systemic reform followed to increase liquidity in the system while also providing central banks with the fire power to defend exchange rate pegs during short term emergencies in order to reduce the need to resort to

⁴¹ See Clive Ponting *A Betrayal of Promise Labour in Power 1964 – 1970* (London: Penguin, 1990)

⁴² See Robert Triffin *Gold and the Dollar Crisis: The Future of Convertibility* (New Haven: Yale University Press, 1961) for the classic exposition of this problem.

deflationary policies. These included an expansion of members' quotas at the IMF and the development of swap agreements between central banks.⁴³ Additionally, the General Agreement to Borrow [GAB] involved an agreement among 10 leading industrial economies to provide \$6bn of additional liquidity to the IMF in the event of a large drawing being required.⁴⁴ Proposals for a new, synthetic form of liquidity, issued by the IMF into which reserve currency holdings could be converted formed the basis of reform discussions during the 1960s. The creation of such a new reserve asset would allow the US to transition to a balance of payments surplus without choking the world of liquidity upon which the growth of trade depended.⁴⁵ However despite agreement being reached on a new Special Drawing Right by 1968 (and Britain's enthusiastic initial adoption of its use) its terms and availability in the face of determined French opposition meant it ultimately played a minor role in global liquidity.⁴⁶

British commitment to Bretton Woods was based on the assumption that with America also concerned about monetary reform, changes to the systematic provision of liquidity targeting the dollar would also include sterling, resolving its international status while also maintaining Britain's integration into the global economy. This assumption was revealed hollow by the fallout from the Nixon Shock. The attitude of 'benign neglect' towards the dollar forced adjustment on other economies; they could either appreciate their currencies to prevent capital inflow or hoard unconvertible dollars. This allowed America to finance its deficits and worldwide commitments without regard to its own reserves.⁴⁷ (see Figure 2.2)

This massive expansion of global liquidity undermined any progress towards reform of liquidity provision that Britain had depended on for resolving sterling's overhang. Meanwhile, the growth of

⁴³ James *International Monetary Cooperation* pp.161-162

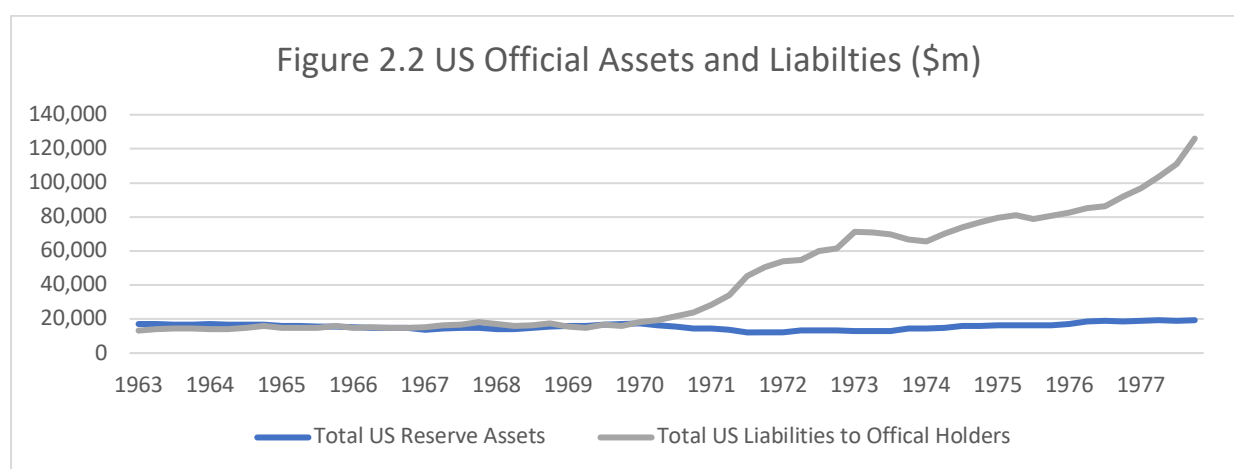
⁴⁴ *Ibid.* pp.152-153

⁴⁵ TNA T312/2145 "Reserve Creation and October IMF Meeting" 3 September 1968

⁴⁶ Mainly as a result of the US Congress being ultimately unwilling to accept paying more on SDRs than it did on foreign holdings of dollars which undermined the attractiveness of the asset, see Robert N. McCauley and Catherine R. Schenk "Reforming the International Monetary System in the 1970s and 2000s: Would a Special Drawing Right Substitution Account Have Worked?" *International Finance* (2015) Vol. 18 (2) p191

⁴⁷ James *International Monetary Cooperation* pp.228 -229; Eichengreen *Globalizing Capital* p117

international trade and the development of multi-national corporations generated both the demand for, and the supply of, international capital markets.⁴⁸ The accumulation of offshore dollars led to the creation of dollar capital markets, known as Eurodollar markets since they were primary based in Europe, particularly London.⁴⁹ The OPEC shock of 1973 resulted in massive surpluses for oil-producing states which, unable to consume them given their size and development, were re-mediated back to oil consuming states, adding a further boost to the re-emergence of global capital flows.⁵⁰



Source: Federal Reserve *Banking and Monetary Statistics, 1941 – 1970* (Washington DC: Federal Reserve, 1970) Table 14.1 “U.S. Reserve Assets, End of Month, 1972-70” Table 15.1 “U.S. Liquid and Nonliquid Liabilities to Foreign Official Institutions, and Liquid Liabilities to All Other Foreigners, Varying Dates, 1949-70”; Federal Reserve *Annual Statistical Digest 1971 – 1975* (Washington DC: Federal Reserve, 1976) Table 59: “U.S. Reserve Assets”, Table 62 “U.S. liabilities to foreign official institutions, and liquid liabilities to all other foreigners”; Federal Reserve *Annual Statistical Digest 1974 – 1978* (Washington DC: Federal Reserve, 1979) Table 49: “U.S. Reserve Assets”, Table 50: “Selected U.S. liabilities to foreign official institutions”

The resumption of global capital flows, and Britain’s growing dependence on them into the 1970s to fund external deficits, raised the prospect that while greater access to the system’s increased liquidity could finance balance of payments deficits on a greater scale than before, the need to maintain market confidence could emerge as a new source of constraint, as argued by the structural accounts of international monetary relations.⁵¹ This was particularly urgent while the sterling

⁴⁸ Margaret de Vries *International Monetary Fund 1972 – 1978 Cooperation on Trial Vol.1* (Washington DC: IMF, 1986), p 99

⁴⁹ Eric Helleiner *States and the Reemergence of Global Finance From Bretton Woods to the 1990s* (Ithaca: Cornell University Press, 1994) p91

⁵⁰ Eichengreen *Globalizing Capital* pp151-152

⁵¹ Clift & Tomlinson “Whatever Happened to the Balance of Payments ‘Problem’?” p620

overhang remained, as markets interpreted the threat posed by diversification as marking sterling as a weak currency, requiring greater retrenchment than otherwise to stabilise the rate.

At the time however, institutional sources of support such as the IMF and BIS continued to provide important sources of liquidity for sterling. Lacking their own surveillance mechanisms, markets sought the IMF's 'seal of approval' before committing the required funds. Lenders were aware that through providing sources of liquidity to Britain they loosened the external constraint, raising the possibility that inappropriate domestic policies could then be pursued. Accordingly, they sought to tie British borrowing to specific conditions that mandated the scope and direction of government borrowing and monetary growth. As Ben Clift and Jim Tomlinson note in their review of IMF conditionality, in response to complaints from developing economies that nations like the UK received easier terms, British drawings from the mid-60s onwards were characterised by a "greater specificity of undertakings, targets and strings attached."⁵² In particular, the IMF attempted to tie British policy to quantitative restrictions according to its pet theory of Domestic Credit Expansion [DCE], but also on the level of government expenditure as expressed in the Public Sector Borrowing Requirement [PSBR]. This process reached its apogee in 1976 when in response to what he perceived as excessive IMF demands, the Chancellor Denis Healey famously told the Fund's Managing Director to "take a running jump."⁵³ However the subjective nature of market opinion meant being seen to accept the Fund's policy prescriptions and thus gaining the IMF's 'seal of approval' could be enough to restore market confidence, thus reducing the chance that supplied funds would actually be drawn upon.⁵⁴

⁵² Ben Clift and Jim Tomlinson "Negotiating Credibility: Britain and the International Monetary Fund, 1956–1976" *Contemporary European History* (2008) Vol. 17 (4) p549

⁵³ Chris Rogers *The IMF and European Economies: Crisis and Conditionality* (Basingstoke: Palgrave Macmillan, 2012) p145

⁵⁴ Clift and Tomlinson "Negotiating Credibility" p565

2.5: Conclusion

This chapter has argued that the continuation of sterling's reserve role and adherence of the monetary system's provision of adjustment, liquidity and confidence involved constraints on Britain's domestic economy and policy. Ultimately however these constraints were determined by Britain's political and ideological commitment to the compromise of embedded liberalism, which was believed to help secure wider objectives. While this commitment implied constraints, they proved negotiable through a process of economic diplomacy that expanded the sources of support available to sterling.

Chapter 3:

Sterling as a Constraint: Literature Review

No analysis of the period between the 1967 devaluation and the 1976 IMF crisis can avoid engaging in the debate over the nature of Britain's supposed post-war decline. As this chapter will demonstrate, concerns over international role of sterling in constraining economic growth have, until recently, dominated the historical narrative. The present thesis continues an ongoing revision of this argument by demonstrating the extent to which the external constraint imposed by the sterling balances was constituted through the nature of Britain's political commitment to the principles of embedded liberalism and was amenable to negotiation through Britain's economic diplomacy.

3.1: Decline and Declinism

As Jim Tomlinson has noted in his overview of 'declinism', British writers and leaders have been concerned about the erosion of British military and economic supremacy since the turn of the 19th century.¹ It was during the great post-war boom however that the extent and cause of Britain's decline, and the search for solutions, became the subject of national debate. Despite the unprecedented growth rate of British living standards during the 1950s and 1960s, the superior performance of the 'economic miracles' experienced by European economies coincided with Britain's political and military retrenchment from Empire to give rise to both popular and elite

¹ Jim Tomlinson "Inventing 'Decline': The Falling behind of the British Economy in the Postwar Years" *The Economic History Review* (1996) Vol. 49 (4) p731

disquiet over reduced power of the British state and the poor performance of the economy upon which power depended.²

Contemporaries and historians working within the declinist tradition from both sides of the political divide have advanced a multitude of reasons for the supposed under-performance of the British economy. A listing of the causes proposed indicates the extent to which the debate touched all aspects of the British polity. To the left, primary causes were the hegemony of finance over investment in industry, the preference for soft Commonwealth and Empire markets over dynamic European ones and a liberal nature of the British state in comparison to the activist, interventionist French one. Right wing observers meanwhile stressed restrictive trade union practices and the private sector being crowded out by public sector investment.³ Even Britain's victory in the Second World War constituted a handicap, as an exhausted but relatively undamaged Britain sought to continue a worldwide military presence. Meanwhile, defeated countries had the benefit of wiping the slate clean, reconstructing with up to date capital stock and securing agreement from management and labour that priority should be given to growth.⁴

The failure to escape from the 'stop-go' cycle of accelerating growth followed by retrenchment led to complaints that sterling's international role was being prioritised over the demands of the domestic economy. The general consensus was that British governments' efforts to re-establish sterling as an international currency were based on considerations of prestige rather than the real needs of the economy and that these efforts actively harmed the prospects for growth. However,

² Andrew Gamble, "Theories and Explanations of British Decline" in Richard English and Michael Kenny [ed.] *Rethinking British Decline* (Basingstoke: Macmillan, 2000) pp. 3-4

³ Tomlinson, "Inventing 'Decline': p. 731; Sidney Pollard, *The Wasting of the British Economy* 2nd edition, (London: Croom Helm Ltd., 1984) pp. 6-18; Scott Newton and Dillwyn Porter *Modernization Frustrated: the politics of industrial decline in Britain since 1900* (London : Unwin Hyman, 1988) p. xiii; Gamble, "Theories and Explanations of British Decline p5

⁴ Mancur Olsen *The Rise and Decline of Nations Economic Growth, Stagflation and Social Rigidities* (Yale: Yale University Press, 1984)

the target of criticism evolved as did the wider Bretton Woods system, suggesting Britain's commitment to the wider monetary system played an important role.

One of the first to grapple with the problem was A. C. L. Day, who wrote *The Future of Sterling* in 1953. This was a time of liquidity shortage in the international monetary system, in which European economies were attempting to conserve hard currency dollars in their trade. Day assigned the effort then underway to achieve sterling convertibility to a misguided attempt to restore the City of London to its former role as the world's premier financial centre. This followed on from the failure to realise that Britain's economic growth now depended primarily on the strength of her manufacturing industry rather than the profits made from international banking and finance.⁵

The real danger however stemmed not from a lack of investment in the domestic economy but rather the threat to sterling from the rush to establish convertibility in a system experiencing a liquidity shortage. The overhang of short-term sterling liabilities to assets, subject to the prospect of increased volatility as the political links with the Sterling Area ossified, threatened insolvency even if the current account of trade and services was balanced.⁶ According to Day it seemed

unwise for a weakened Britain to take upon herself the position of pivot of the world's payment system, unless there is a very adequate cushioning system available to absorb the inevitable shocks. At the moment this cushioning is clearly quite inadequate.⁷

Day understood the constraint imposed by the sterling balances was not easily evaded. Funding the balances via a long term amortisation would require a substantial drain on British resources through payments on the debt, while increasing British assets to a level commensurate with liabilities would involve years of sustained surplus which would represent investment foregone in domestic industry.⁸ Day recognised early on that the best solution lay in an increase in global liquidity which

⁵ A. C. L. Day *The Future of Sterling* (Oxford: Clarendon Press, 1954) p153

⁶ *Ibid* p157

⁷ *Ibid* p9

⁸ *Ibid* p164-165

could cushion the impact of sterling diversification on the domestic economy. For this he looked to the Americans, noting that while both sterling and the dollar were international currencies, only the dollar was universally acceptable.⁹ While hoping therefore for an American driven increase in liquidity, Day also worried about the unpredictability of the US, noting how foreign trade was peripheral to her economy and global interests subordinated to domestic ones in her formulating of economic policy. He therefore hoped for a reformed system more resilient to shocks emanating from the US and while recognising the crucial nature of the Anglo-American relationship, presciently warned that “no economic policy for the rest of the world can be safely founded on an assumption of a stable American policy.”¹⁰

In an influential analysis in 1958, Andrew Shonfield undertook a devastating critique of British post-war economic policy that became one of the foundational texts of declinism. Taking as his central thesis that British politicians needed to “learn to grow faster in wealth” Shonfield explained that contemporary concern over inflation and disappointing growth stemmed Britain’s “stubborn refusal to invest in the creation of more productive capacity,” contrasting domestic rates of capital accumulation unfavourably with the faster growing economies of western Europe and Japan.¹¹ Sterling’s international role played a key part of Shonfield’s argument. He excoriated successive Chancellors for prioritising external surplus over domestic investment, resulting in economising at home to free up resources for export, including capital goods which could have been used domestically.¹²

The persistent weakness of the balance of payments constrained growth as industrial investment became the first item to be sacrificed by any government seeking to reduce the external deficit.¹³ Why then was the balance of payments weak? Shonfield noted the excessive burden of foreign

⁹ *Ibid* p168

¹⁰ *Ibid* pp.7-8

¹¹ Andrew Shonfield *British Economic Policy Since the War* (London: Penguin, 1958) p15, 42

¹² *Ibid* p31

¹³ *Ibid* p50

military expenditure and private international investment but paid particular attention to the nature of the sterling balances within a shifting international economy. Although Britain had managed to rebuild its foreign assets since the war, the cost of servicing its liabilities, in particular the sterling balances, had also increased. Thus, the net investment income received from foreign investments paid for only 4% imports in 1956 compared with 20% before the war. This stock of debt constrained the management of the British economy in the form of interest payments. In the 19th century when Britain was the world's largest creditor and money market, interest rates could adjust the flow of foreign borrowing by keeping money at home rather than flowing abroad. Now when servicing the sterling balances, an increase in rates resulted in further net outflow in the form of interest payments.¹⁴

The root cause of this problem was, Shonfield argued, psychological, the result of "great power maladies" that insisted on trying to perpetuate Britain's worldwide role through excessive overseas military spending and foreign investment.¹⁵ At the centre of this was the "obsession with the status of sterling as a reserve currency," referring to the argument made in 1957 by the then Chancellor Peter Thorneycroft that "it brings us a great deal in the way of wealth, strength and prestige," to suggest that the last factor was overwhelmingly the most important.¹⁶ Following on from this delusion led the real impact of prioritising the needs of the Sterling Area, including access to the City of London to incentivise holders to keep their balances deposited there, while starving British industry of funds for investment.¹⁷ In response, he called for massive domestic investment drive, protecting the balance of payments through cutting back on military expenditure and overseas investment. He also envisaged a long-term guarantee on official sterling balances in order to manage their withdrawals which, combined with increased domestic capital controls and the assumption of

¹⁴ *Ibid* 72-73

¹⁵ *Ibid* 122

¹⁶ *Ibid* p151, 157

¹⁷ *Ibid* p127

British owned securities by the government, would provide the firepower to manage diversification by the Sterling Area.¹⁸

The arrival into power of a Labour party committed to raising the growth of the economy through a National Plan for industry raised hopes that a solution based on the French experience was at hand. Almost immediately however these hopes were dashed by the need to defend sterling. Fred Hirsch, writing in 1965, argued that the decision not to devalue upon coming to power undermined the prospects of faster growth as well as social reform.¹⁹ This represented a shift in the focus of criticism of Bretton Woods, away from a shortage of liquidity and towards problems with adjustment. While conceding some deflation was necessary in 1964 in response to an overheating economy and in order to move resources into exports, Hirsch argued that only in combination with a devaluation of the pound could it have provided the framework for a “belated twentieth century economic miracle that many believed Britain was due for.”²⁰

Hirsch identified three sources of pressure on sterling: the deficit on the current account caused by weak export performance; excessive capital outflow from military spending and private investment; and a run on the sterling balances provoked by an inadequate reserve of short-term assets against liabilities. The post-war experience had been characterised by all three, often simultaneously. The latter however was particularly significant as it exaggerated disturbances caused by trading deficits while simultaneously making the same deficits harder to resolve by creating a barrier to devaluation which Hirsch viewed as the best solution to the British deficit. Sterling’s reserve function meant policymakers resisted devaluation as well as refrained from limiting capital outflow in order not to upset the Sterling Area and provoke diversification.²¹ A large measure of blame was laid at the door

¹⁸ *Ibid* pp.265-270

¹⁹ Fred Hirsch *The Pound Sterling* p14

²⁰ *Ibid* p15

²¹ *Ibid* p25

of the Bank of England. Devaluation was held by the Bank to be inconsistent with sterling's reserve role upon which the City's banking functions were believed to depend.²²

Hirsch proposed a floating exchange rate for sterling, both to effect a more orderly process of adjustment while also acting as a spur to international reform of the role played by currencies in international reserves.²³ Writing at a time of declining confidence in both sterling and the dollar, Hirsch argued for the liabilities of both countries to be assumed by the IMF whereby Britain and America would accept a guarantee of the value of their currencies (expressed in gold) in return for the IMF acting as a "considerate holder" which would draw down its balances only when the currencies were in demand and their respective economies in surplus.²⁴ In doing so, Britain would be removed from the constraint of the sterling balances which were a legacy of the war and no longer imparted any benefit on the economy.²⁵

More sympathetic to the City was economics editor of the *Financial Times* Samuel Brittan, who nevertheless arrived at a similar conclusion to Hirsch. Brittan described the contemporary concern with the balance of payments and the stop-go cycle as a "pseudo-problem" resulting from the attempt to maintain an inappropriate exchange rate and/or over expansionary domestic policy.²⁶ Brittan argued the exchange rate was an area in which the government had the power to make a decisive policy at speed but under Bretton Woods successive administrations had rejected action in favour of a series of moral exhortations including "export drives, incomes policy, 'Back Britain' drives, travel allowances, consultations with industry and knighthoods for exporters," in which the impact of government was indirect and where any success would take years to materialise.²⁷ A false price given by an permanently overvalued exchange rate distorted the economy while under Bretton

²² *Ibid* p46

²³ *Ibid* p91-92

²⁴ *Ibid* p96

²⁵ *Ibid* 111

²⁶ Samuel Brittan *The Price of Economic Freedom: A Guide to Flexible Rates* (Basingstoke: Palgrave Macmillan, 1970) p. xi

²⁷ *Ibid* p12, 22

Woods adjustment had come to be perceived as a last resort, taking place in large jumps rather than the smooth, continuous adjustment implied by a floating rate.²⁸

Brittan was careful not to position floating sterling as a panacea. Despite writing in 1970 at a time when the devaluation of 1967 had finally produced a surplus, he warned that this was likely to be the temporary result of a combination of favourable forces including a credit squeeze, import deposits, low growth and the residual impact of devaluation which would be undermined by the current “explosion” of wages and the cost of joining the EEC.²⁹ Brittan was concerned that a floating rate must be accompanied by “sensible” internal policies, involving deflating the economy to move resources to exports and import-saving industries.³⁰

Brittan did not view liquidity under Bretton Woods as a constraint on British policy, rather the opposite. Given the government’s commitment to fixed exchange rates, this required prompt adjustment in the form of deflation at the first sign of an external deficit. Instead however, the generous support available via the IMF and central bank credits, coupled with the prospect of devaluation as a last resort meant imbalances were given time to build, resulting in a more painful and extended adjustment when it finally arrived. He therefore gave short shrift to the prospects of liquidity reform then underway.³¹ Nor were the existence of the sterling balances held to be a direct constraint on the British economy. Although referring to the “misplaced pride” which has precluded funding the sterling balances at the end of the war, he noted post-war build-up had softened the impact of reconstruction, meaning without them pressure on reserves would have been even greater.³² Instead the constraint imposed by the existence of sterling balances was an indirect one,

²⁸ *Ibid* p11

²⁹ *Ibid* 15

³⁰ *Ibid* p65

³¹ *Ibid* p5, 10

³² Samuel Brittan *Steering the Economy: Role of the Treasury* (London: Penguin, 1971) p260

through inhibiting the government against devaluation or floating the currency for fear that if used by a reserve currency this would provoke a stampede for the exit.³³

Despite writing at a time of significant change in the world's international monetary system, Brittan was sanguine that the reforms secured since 1967 could help manage a sterling float while the economy was still in surplus, providing for a more effective process of adjustment once a deficit reappeared. Devaluation and the partial demonetisation of gold meant that a run on the dollar was less likely, while the Second Group Arrangement whereby sterling was provided with a credit line with the BIS and a commitment by the sterling balance holders to keep a minimum proportion of their reserves in sterling in return for a dollar guarantee of their value "ought to mean the end of the old sterling balance problem." This was to overlook just how attractive these guarantees were, facilitating a fresh build-up of balances while Britain struggled to adjust to the post 1973 inflationary oil crisis.³⁴ Brittan also failed to predict that although floating did not rule out deflationary action on the part of the government, it did not rule it in either, resulting in the Barber Boom being unchecked by any need to defend the rate, with consequences down the line for the sterling balances culminating in the IMF crisis.

Sterling's problems in the 1970s prompted the nascent field of International Political Economy to use it as a case study in its examination of the role of reserve currencies. At the beginning of the 1970s, Susan Strange analysed sterling through a typography reproduced below that conceptualised currencies according to the political economy of their use.

³³ *Ibid* p261-262

³⁴ Brittan *The Price of Economic Freedom* p68

Table 3.1 Susan Strange's Politics of International Currencies.

Form	Features
Top Currency	Issues in and/or backed by the state that exercise/enjoys world economic leadership, i.e., the dominant state in the world market
Master Currency	Circulates mostly in geo-political blocks, e.g., thanks to the political dominance of issuing state
Negotiated or political currency	Tied to international regimes with emphasis on mutual benefits rather than coercion
Passive or neutral currency	Circulates domestically, minor role in international regimes.

Source: Strange *Sterling and British Policy* p5

According to Strange, sterling's post-war experience was explained by its status as a Negotiated Currency, one in which the issuing state had lost the position of political and economic leadership that had once made sterling both a Top Currency and a Master Currency. Sterling's status as a Negotiated Currency resulted in a need to bargain with holders over the terms on which they would continue to use it as an international currency.³⁵ This imposed a defensive posture on British governments, requiring inducements in the form of military spending or access to London capital markets to preserve sterling's international role. As Strange noted:

The Master Currency depends heavily on the stick. But if the stick is weakened or if the issuing state for any reason becomes too embarrassed to use it, then it must be replaced by carrot³⁶

³⁵ Strange *Sterling and British Policy* p5

³⁶ Susan Strange "The Politics of International Currencies" *World Politics* (1971) Vol. 23 (2) p220

In explaining why Britain endured the constraint implied by sterling's reserve role, Strange also resorted to psychological arguments, coining "Top Currency syndrome", a belief that the interests of the world economy were also the interests of the British economy.³⁷ The loss of sterling's international status was only slowly perceived, initially obscured by Britain's temporary advantage following victory in the war, the existence of the Sterling Area (large parts of which were still under British political control) and the absence of general convertibility which meant British policymakers could continue in the belief that sterling would remain an international currency second only to the dollar.³⁸

This failure to adapt to Britain's decline and the determination to preserve sterling's status as an international currency therefore imposed a constraint on the domestic economy. The need to defend the exchange rate, the increasing burden of aid, trade and security concessions to members of the Sterling Area and reluctance to interfere in the business of the City facilitating capital outflow all combined to act as a drag on the growth of the domestic economy.³⁹ Although towards the end of the 1960s a shift in opinion could be detected in both the City and Westminster that asked whether Britain might be better off without sterling's reserve role, the responsibility felt towards the fate of the international monetary system caused by 'top currency syndrome' continued to prevent any consideration of radical changes in the commitments taken on by sterling.⁴⁰

Of particular relevance is Strange's focus on the importance of the Anglo-American relationship to sterling's preservation as an international currency, noting that sterling would have collapsed had it not been for American financial support and its forbearance in pushing for an end to the discriminatory Sterling Area.⁴¹ The analysis was continued by a generation of historians writing in the 1980s and 90s who related the defence of sterling to the needs of the "special relationship" with

³⁷ *Strange Sterling and British Policy* p47

³⁸ *Strange Sterling and British Policy* p298-299

³⁹ *Ibid* p300

⁴⁰ *Ibid* p302

⁴¹ *Ibid* 61

America upon which Britain's post-war great power depended. Clive Ponting's review of the 1964-70 Labour government, provocatively entitled *Breach of Promise*, claimed that the promise of Wilson to remake the British economy according to a National Plan was betrayed by the need to placate American geopolitical interest in order to secure financial support for sterling. Britain made a commitment not to devalue, restrain internal demand and maintain the burden of military presence in the Far East in return for American dollars.⁴² Echoing Hirsch, Ponting contended the refusal to devalue in 1964 wasted an opportunity for sustained growth in British output and exports, succumbing instead to a series of exchange crises and successive rounds of deflation, failing on its own terms when devaluation finally occurred in 1967.⁴³

The argument that Britain's desire to continue a worldwide role prioritised the interests of sterling over the needs of domestic economy is a consistent theme in the historiographical record. Peter Clarke argued that defence of an overvalued exchange rate militated against a National Plan while requiring an incomes policy that undermined support for Labour among the unions.⁴⁴ A vicious circle arose in which defence cuts required to stabilise sterling were ruled out by the nature of Wilson's agreement to maintain a presence east of Suez in return for American support.⁴⁵ David Reynolds argues that Britain's post war experience was characterised by a growing dependence on American support in order to play a world-wide role. The influence afforded by the Commonwealth and the Sterling Area, upon which it was assumed British prosperity depended, evaporated in the wave of decolonisation from the mid 1950s onwards, while the need to defend sterling diverted British attention from European integration, with disastrous consequences.⁴⁶

Sidney Pollard likewise draws on the historical influence of Empire in constraining the growth potential of the British economy. The existence of the sterling balances, requiring high interest rates

⁴² Ponting *Breach of Promise* p191

⁴³ *Ibid* p200

⁴⁴ Peter Clarke *Hope and Glory Britain 1900 – 1990* (London: Allen Lane, 1990) p311

⁴⁵ *Ibid* p312

⁴⁶ David Reynolds, *Britannia Overruled: British Policy and World Power in the Twentieth Century* (London: Longman, 2000) p190, 195-196

in order to maintain confidence while also postponing devaluation until 1967 was a direct constraint on the economy inherited from Empire, in which the problem was compounded by Britain's heavy overseas expenditure, itself made necessary by the need to induce sterling holders to maintain their balances through aid and security concessions worldwide.⁴⁷ The defence of sterling incurred costly obligations to international institutions which also diverted investment away from the domestic economy.⁴⁸

In summary the declinist thesis held that Britain's post-war economic performance was hindered by a lack of domestic investment. The consensus was that Britain's external commitments, either to stability of the international monetary system, the international role of sterling or building up private foreign investment, was a major cause of this lack of investment and hence a constraint on growth. This has usually been given a psychological explanation – the 'delusions of grandeur' thesis - whereby British post-war leaders attempted to continue playing a world role long after the economy stopped being able to afford it.

3.2: Revisionist Interpretations of Sterling's Decline

More recent historical investigation has challenged the 'declinist' hypothesis, challenging the fundamental notion of decline due to failure of policymaking by noting that the performance of the economy in terms of growth, unemployment, inflation and balance of payments deficit was superior from 1951-73 than it was from 1979-97.⁴⁹ Externally this revisionist approach has been taken furthest by Catherine Schenk, whose work has examined the post-war retreat from sterling's international status within the context of the international monetary system. Focusing on the evolution of the Sterling Area, Schenk has argued that during the 1950s the system provided mutual benefit to both Britain and the other members. The latter received access to London's capital market at a time of restrictions on foreign investment, while the mutual pooling of members dollar holdings

⁴⁷ Sidney Pollard, *The Development of the British Economy 1914 – 1990* (London: Hodder, 1992) p312

⁴⁸ *Ibid* p313

⁴⁹ Jim Tomlinson *Balanced Accounts*

in London bolstered the foreign exchange reserves available to defend sterling. With the majority of trading relationships between members denominated in sterling, there was a mutual interest in maintaining the stability and value of the currency.⁵⁰

Schenk revised the declinist arguments that the Sterling Area represented the domination of financial over industrial interests, that restrictive domestic policies were necessary to support the pound and that excessive foreign investment was required to maintain the coherence of the area, taking preference over domestic investment.⁵¹ Instead the availability of the Area's dollar holdings helped loosen the UK's balance of payments constraint, whereas otherwise the economy would have had to have been deflated further to bring the external account back into balance.⁵² Noting the low productivity of domestic investment, Schenk argues that capital outflow was not drag on British growth it has been commonly portrayed, instead creating demand for British exports while also building up supply of oil through Britain's continued role in the Middle East and generating invisible earnings for the balance of payments.⁵³ Instead she criticises the traditional perception of the balances as a "homogenous mass of short term liabilities hanging over the central reserves" as mistaken.⁵⁴ The supposed imbalance of liabilities to assets was both misleading and damaging to confidence; Britain's net overseas position was positive. Although Britain's pattern of long term investment meant a large share of these assets were illiquid, the liquidity of the liabilities was also exaggerated. Publication of the size of the total balances was not mirrored by a proper accounting of the resource available to Britain, focusing only on Britain's holdings of gold and foreign reserves and not taking into account the support available from the IMF and central bank swap arrangements which could be quickly activated to defend the rate.⁵⁵

⁵⁰ Catherine Schenk "The Sterling Area and Economic Disintegration" *Geschichte und Gesellschaft* (2013) Vol. 39 (2) p. 11

⁵¹ Catherine Schenk *Britain and the Sterling Area: From Devaluation to Convertibility* (Abingdon-on-Thames: Routledge, 1994) pp.5-7

⁵² *Ibid* p29

⁵³ *Ibid* p112

⁵⁴ *Ibid* p20,

⁵⁵ *Ibid* p29, 35

In the most extensive review of sterling's post-war retreat from its international role, *The Decline of Sterling*, Schenk extends her revisionist argument into the 1960s and 1970s, contextualising the travails of the currency during this period with regard to the evolution and crisis of the world's international monetary system and the impact this had on sterling as the world's second reserve currency. The development of the world economy through the 1960s shifted the relative benefits and costs accruing to both Britain and the Sterling Area, resulting in the retirement of sterling as an international currency. The growth of global capital markets, particularly in offshore dollars traded in London (the so-called Eurodollar markets), reduced the attractiveness of access to London's sterling markets for members of the Sterling Area while also undermining the belief that the City of London's business depended on sterling's international role.⁵⁶ At the same time, Britain's growing orientation towards Europe threatened the long term trading relations upon which the Sterling Area was built, while also impressing on the negotiators of Britain's three attempts to join the EEC that sterling's reserve role was viewed in Europe as a burden that Britain's prospective partners were reluctant to assume.⁵⁷ The interdependence of the global economy combined with the complexity of Britain's economic and political relations both with Europe and worldwide meant the sterling balances defied unilateral fixes, instead relying on multilateral negotiation within the context of international reform. Defaulting on the debts incurred as part of the sterling balances was not a serious proposition for a country as dependent on trade as Britain, particularly at a time of stress in the global economy resulting from concern over the future of the dollar.⁵⁸

Schenk criticises the 'delusions of grandeur' thesis, noting that even in the 1950s British governments were ambivalent to sterling's international role, recognising it as a source of friction with the United States, Europe and the Commonwealth. The evolution of monetary system, in which

⁵⁶ Catherine Schenk "The Origins of the Eurodollar Market in London: 1955 -1963" *Explorations in Economic History* (1998) Vol. 35 p.235

⁵⁷ Catherine Schenk "Sterling, International Monetary Reform and Britain's Application to Join the European Economic Community in the 1960s" *Contemporary European History* (2002) Vol. 11 (3) pp. 345-346

⁵⁸ *Ibid* p6

foreign currencies came to supply the liquidity required to maintain the growth of world trade meant sterling occupied an important structural role, second only to the dollar. The major sterling balance holders had limited options available given the dollar was also weak while surplus economies like Japan and Germany resisted the internationalisation of their currencies. Moreover, a rush to the exit could provoke a collapse in sterling and hence the value of their holdings. Consequently, there developed a collective interest in perpetuating sterling's reserve role on behalf of the stability of the world economy.⁵⁹

Rather than seeking to prolong sterling's reserve role at cost to the domestic economy, British governments instead sought to leverage its structural importance to manage its decline at least cost to the international trade and financial links upon which domestic prosperity depended. The 1960s witnessed decisive action on the part of successive British governments to withdraw from Britain's continuing worldwide role, including its military presence 'east of Suez' as well as the reserve role of sterling, against the wishes of the American administration upon whose support sterling depended, in order to divest Britain of the impediments to assuming a European role.⁶⁰ The turmoil of the international monetary system following sterling's devaluation in 1967 provided British with leverage (in the form of the threat posed by a further devaluation) to secure international support on generous terms. According to Schenk:

the hard bargains driven by British negotiators and the evidence that the contractionary terms of the IMF or American credits were not honoured rather contradicts the usual interpretation, that the interests of the domestic economy were sacrificed to the international status of sterling.⁶¹

As well as short term support to defend the rate, the debate over the future role of reserve currencies raised the prospect that global reform to the system's provision of liquidity offered the potential for a long term solution of the sterling balances in the form of substitution into a new asset

⁵⁹ *Ibid* p30-31

⁶⁰ *Ibid* p117

⁶¹ *Ibid* p204

created and administered by the IMF. This process ultimately amounted to minor revisions to the world's monetary system, becoming bogged down in debates between American and the French over the role of gold amid wider disagreements concerning burden sharing in defence and discrimination in trade. Nevertheless, concern over the future of sterling was significant enough for a series of negotiated support packages to support sterling diversification arranged via the BIS.⁶² The final coup de grace for sterling was negotiated in 1977 with the Third Group Arrangement. Schenk reinterprets the significance of the IMF crisis of 1976 with regards to the retreat of sterling, noting the negotiation of the BIS arrangement subsequent to the IMF deal represented the culmination of the long term strategy to retire sterling with the support of the international community, successfully engaging international support for sterling and mitigating the domestic restraints or external barriers that would be required in absence of such support.⁶³ As such the constraint imposed by sterling's reserve role was less to do with the delusions of a continuing world role but rather with the evolving structure of the international monetary system, which were successfully negotiated by governments on agreeable terms representing the least cost to the domestic economy.

While Schenk has covered the period under consideration in detail, the present thesis seeks to build on her approach by presenting a single narrative investigating the continuing use British policy made of the sterling balances following devaluation, while expanding the liquidity available to mitigate the constraint they imposed. This enables us to better understand the terms of the engagement with the IMF (and the US government) in 1976 by comparing and contrasting with the evolution of previous support packages since 1967 amid change in the international monetary system's provision of adjustment, liquidity and confidence.

⁶² *Ibid* p271-272

⁶³ *Ibid* p430

Chapter 4

The Battle for Bretton Woods

4.1: Introduction

For the British Ambassador to the United States Sir Patrick Dean, 1968 began with his annual report on the state of Anglo-American relations. Following sterling's devaluation little over a month previously, Dean was concerned. Speculation over the status of the dollar was destabilising the wider Bretton Woods monetary system. To compound matters, the Labour government was accelerating Britain's withdrawal from its remaining worldwide military commitments in order to reduce capital outflow and restore balance in international payments. Together, these developments threatened to undermine the monetary, trade and security architecture that had fostered cooperation and integration between Western economies in the post-war period. For a generation of politicians that had come of age during the turmoil of the interwar years, this was an alarming prospect.

In his report, Dean reported that the Americans were not only sympathetic to the plight of the British, but "positively anxious," that the policies to stabilise sterling were successful, if only because of the effect failure would have on the dollar. However, despite recognising that some of the adjustment would have to fall on Britain's defence budget, they were nevertheless "greatly alarmed," at the prospect that a hasty withdrawal would threaten the West's control of "unique political and strategic assets" in Europe, the Middle East and South East Asia.¹ American support for sterling could be undermined if Britain was no longer perceived to be pulling its weight in global affairs. As Dean noted:

¹ TNA PREM 13/3551 Telegram from Washington to Foreign Office 004" 01 January 1968

Much of the American Press reporting from London presents an image of the British public fiddling while Rome is burning. The insouciance of "Swinging London", the constant and irresponsible pressure for wage increases and the much-publicised strikes of recent months...the alleged frivolity and preoccupation with private and public welfare excites the Puritan lurking in every American.

The impact of this view on the executive branch of the US government would, Dean felt, be limited by America's self interest in British retrenchment. A bigger problem was Congress (the symbol of "American Puritanism and hypocrisy") – which ultimately controlled the purse strings:

If they convince themselves that the United States is in some way subsidising the British welfare state while we are shifting more of our defence burden on to American shoulders, they could make it very difficult indeed for the Administration to provide the financial support we need when sterling is in trouble.²

Dean pleaded for this to be considered when formulating policy. He argued that despite the sometimes excessive demands of the Americans, their continued support was vital. This was to prove a prescient assessment of what was to follow over the next ten years.

The immediate aftermath of sterling's devaluation was a crisis that threatened the very existence of Bretton Woods. Speculation over the dollar, franc and Deutschmark further weakened confidence in sterling, leading to successive rounds of international borrowing to defend the rate. Although in hindsight this was beginning of the end for Bretton Woods, policymakers on both sides of the Atlantic remained committed to the system's defence. As late as 1970 they could congratulate themselves of having succeeded in stabilising the system and laying the groundwork for significant reforms. This political decision to commit to the defence and reform of the Bretton Woods system and the priority given to its stabilisation over other objectives in economic diplomacy (namely removal of the sterling overhang), were key determinants of the external constraint faced by Britain during the post-devaluation period.

² *Ibid*

The post-devaluation period has traditionally received less attention from historians, appearing as a post-script to the events leading up to devaluation. “Two years hard slog,” as the Chancellor Roy Jenkins remembered it, in which Britain struggled to achieve surplus on the external account. More recently there has been a growing interest in this period. Michael Oliver and Arran Hamilton have detailed the continuing exchange crises afflicting sterling post-devaluation as well as the contingency plans drawn up in the Treasury to deal with them, including floating sterling and blocking the sterling balances.³ Separately, Hamilton has argued the Gold Crisis in March 1968 represented a much more dangerous threat to sterling than its devaluation the previous year, given that reserves to defend the rate were even lower at this point.⁴ Scott Newton has shown that the post-devaluation struggle to defend the new rate threatened the ability of Labour to maintain a social-democratic order in Britain as instability around Bretton Woods combined with the continued development of global capital markets to destabilise sterling.⁵ Together these analyses highlight the extent to which, as Wilson noted in his television address, devaluation was ‘not the end of the affair but the beginning of a long and dangerous process which could lead us not upwards but still further downwards.’⁶

For Catherine Schenk, the devaluation marked “the great turning point” in sterling policy, prompting the search for mechanisms by which its international role could be safely diminished, although it was not until the third EEC membership application in 1971 that this became an explicit British policy.⁷

For the sterling balance holders, devaluation led to a “profound sense of betrayal,” reinforced by the subsequent decision to withdraw militarily ‘east of Suez,’ as traditional trade, finance and security links between Britain and the OSA ossified, threatening mass diversification which could sink attempts to hold the rate.⁸ Given the reliance of British prosperity on external trade (and hence a stable monetary system), this was a complex task beyond the reach of Britain alone, requiring

³ Oliver & Hamilton “Downhill from Devaluation” p497

⁴ Hamilton “Beyond the Sterling Devaluation” pp. 73 – 95

⁵ Newton “Sterling, Bretton Woods and Social Democracy” pp. 427-455

⁶ Oliver & Hamilton “Downhill from Devaluation” p506

⁷ Schenk *The Decline of Sterling* p117

⁸ *Ibid* p313

instead multilateral negotiation to secure sterling's immediate stability and future retirement from its role as a global currency.⁹ Sterling's key role in Bretton Woods allowed Britain to secure a series of financial support packages from the IMF, leveraging the threat of a second devaluation or floating the currency to "strike fear into the heart of the IMF and Johnson administration."¹⁰ However, hopes for a more comprehensive solution to the sterling balance problem via reform of Bretton Woods liquidity resulted in "confused and inconclusive," discussions, culminating in the Special Drawing Right which was ultimately unable to prevent the collapse of the system amid concern over the status of the dollar. Combined with Labour's reluctance to concede policy oversight to the IMF, the tentative status of reform prompted the search for alternative sources of support, notably the BIS which, it was felt, could be relied upon to make less intrusive demands on British policy autonomy. The resulting Second Group Arrangement organised by the BIS and corresponding Sterling Agreements negotiated with 34 individual members of the OSA, stabilised sterling but also reflected the extent to which traditional relationships had eroded and needed replacing with a "formalised network of bilateral contracts."¹¹

From the perspective of the 1976 crisis, this thesis argues that the years after devaluation was the period of greatest adjustment for Britain's integration into the global economy, requiring a proportionally greater degree of retrenchment both at home at abroad and higher borrowing to defend the rate, at a time when domestic fundamentals were nevertheless in better shape. On the other hand, financial support to stabilise sterling was more readily available. Both factors are explained by the joint Anglo-American commitment to Bretton Woods' defence and reform. With both sides fearful that a collapse in the system could herald a return to the economic and political conflict of the interwar years, stabilising Bretton Woods assumed priority over other British objectives in economic diplomacy.

⁹ *Ibid* p121

¹⁰ *Ibid* p204

¹¹ *Ibid* pp.23-24

Once devaluation had occurred therefore, it was recognised that no further movement on the exchange rate could occur without fatally undermining Bretton Woods. Despite concerns in 1968 that devaluation had not been large enough to restore balance, a second devaluation or floating were considered only as an emergency response to an external crisis.¹² Paradoxically therefore, devaluation reinforced rather than loosened the adjustment constraint.

Defending the rate amid the turmoil of repeated exchange crises involving the dollar, franc and DM required international support, which was obtained on a scale proportionally greater than in 1976.¹³ The symbiotic relationship between sterling and Bretton Woods meant this was available with much less public disagreement than ten years later. IMF attempts to tie lending to conditions in the form of public borrowing or control of the money supply were easily handled by the Treasury. However, as well as withdrawing from Britain's expensive worldwide military commitments, Labour also responded to devaluation with a proportionally greater shift in public borrowing than in 1975/77 (albeit from a lower starting point), achieving a rare budget surplus in 1969 to coincide with the return to external surplus.¹⁴

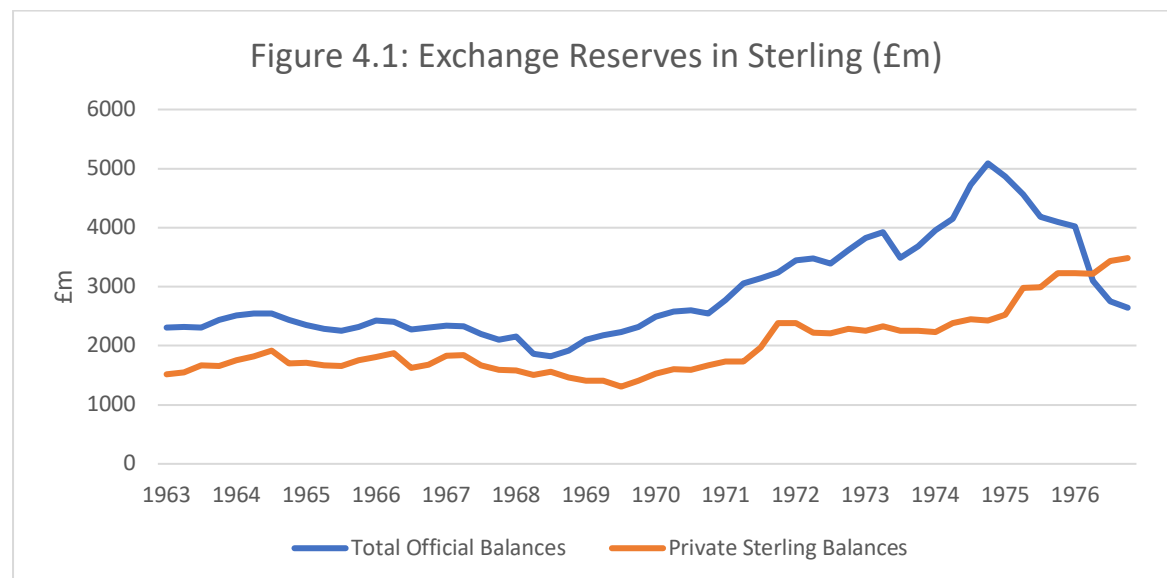
From the point of view of policymakers, these sacrifices were justified as Bretton Woods provided the framework for trade and investment that would drive British growth in the post-devaluation period, while expecting general reform to the system's provision of liquidity would resolve sterling's international status and with it the constraint imposed by the overhang. As such, although financial support for sterling was easily available and not tied to domestic policies beyond those Labour were already pursuing, externally they were predicated on the continuation of Bretton Woods. These involved commitments that look expensive in hindsight. Restoring confidence to sterling balance holders amid the threat of diversification (at a time when the ratio of reserves to liabilities was lower than in 1976), took the form of expensive exchange rate guarantees and high interest rates under

¹² Oliver & Hamilton "Downhill from Devaluation" p497

¹³ Comparisons between 1967 and 1976 are expressed as a % of GDP where possible, since the inflation Britain experienced in the 1970s distorts comparisons expressed at current prices.

¹⁴ Bank of England, Quarterly Bulletin 1984 Q4 "Funding the Public Sector Borrowing Requirement 1952-83"

the 1968 Basle deal. In contrast to the 1977 Basle deal, when an offer of foreign currency bonds to facilitate diversification combined with a commitment to prevent future accruals reduced overseas holdings to working balances, the 1968 instead resulted in a build-up of sterling balances. This reversed the previous decline in the balances and began the fresh build-up that would eventually need to be resolved ten years later (see Figure 4.1)



Source: Bank of England, *Quarterly Bulletin* 1974 Q2 "Overseas Sterling Balances 1963 – 1973" 1974; Bank of England *Quarterly Bulletin*, 1975 Q1 Table 25: "Exchange Reserves in sterling; and banking and money-market liabilities in sterling to holders other than central monetary institutions"; Bank of England *Quarterly Bulletin* 1977 Q1, "Table 19, Exchange Reserves in sterling; and banking and money-market liabilities in sterling to holders other than central monetary institutions,;" Bank of England *Quarterly Bulletin* 1979 Q1 "Table 15: Exchange Reserves in sterling; and banking and money-market liabilities in sterling to holders other than central monetary institutions"

The short-term success in restoring stability to Bretton Woods, as well as some progress on international monetary reform by 1970 appeared to vindicate this strategy. Subsequent events would prove that it was ultimately dependent on the Americans' own attitude towards Bretton Woods. While the Johnson administration remained committed to reform, Washington was a reliable source of financial support and institutional influence. However, the turmoil unleashed on the dollar by sterling's devaluation prompted an American reappraisal of the constraints imposed by its own political commitment to Bretton Woods. The chain of events this led to would have dramatic consequences for attempts to resolve the sterling overhang.

4.2: Dealing with Devaluation November 1967

For Britain, the devaluation of sterling on 19 November 1967 from \$2.80 to \$2.40 was the culmination of a three-year struggle to defend the rate which had begun immediately upon Harold Wilson's Labour government coming to power. The decision to rule out devaluation in 1964 provoked widespread criticism that by doing so Labour prioritised the demands of international financial markets over domestic investment, which required reducing government expenditure and domestic growth in order to defend the rate.¹⁵ By the beginning of 1967 however, the strategy appeared to be working. The British economy was moving from "crisis to convalescence" according to *The Times*, as balance of payments figures released for the final quarter of 1966 showed a surplus of £121m.¹⁶ Summing up his budget speech in April, the Chancellor Jim Callaghan drew an analogy from his service in the Navy: "The economy is moving ahead. Every seaman knows the command at such a moment – 'Steady as she goes'."¹⁷

The decline to devaluation was nevertheless swift, the combination of domestic and international crises that undermined confidence in the currency. According to Wilson's memoirs, devaluation became inevitable when the economic consequences of crisis in the Middle East following the Six Day War were compounded by dock strikes in London and Liverpool.¹⁸ Although a Middle East oil embargo on supplies to the West following the Six Day War was lifted in September, expectations of a change in parity had been raised in international currency markets and were exacerbated by a publication from the EEC implying that the currency would need to be devalued before Britain's prospective membership bid could be accepted.¹⁹ Despite a raise in the Bank Rate in October – characterised by President Johnson's special advisor Walt Rostow as part of a "last ditch British

¹⁵ Ponting *A Betrayal of Promise*

¹⁶ "Britain Pays off \$625m Debt" *The Times* 9 March 1967; "Surplus of \$121m on Payments" *The Times* 16 March 1967

¹⁷ James Callaghan *Time & Chance* (London: Politico, 2006) p214

¹⁸ Harold Wilson *The Labour Government 1964 – 1970 A Personal Record* (London: Michael Joseph Ltd., 1971) p439

¹⁹ Toniolo *Central Bank Cooperation* p398

effort” to hold the sterling parity – it was not enough to restore calm to markets which had expected a bolder move.²⁰

Wilson’s view has been endorsed by revisionist historians who stress instead the “extraordinary combination of events” rather than policy failure that led to devaluation. These include deflationary policies in the US and Germany, unfavourable shifts in international interest rates as well as dislocation stemming from the closure of Suez Canal in response to the West’s support of Israel.²¹

Moreover, as Tim Bale argues, the experience of defending the rate over three years allowed Wilson to justify devaluation to the international community as inevitable, despite the dislocation he knew it would cause, forced upon Britain due to the ‘fundamental disequilibrium’ of sterling’s position and therefore permissible according to the ‘rules of the game’ prevailing under Bretton Woods.²²

Presenting the decision to a domestic audience, Wilson argued devaluation offered the potential for Britain to breakout of “rigid limitations on the ability of our people and government to solve our problems by our own exertions,” concluding his speech by asserting “we are on our own now – it means Britain first.”²³ Both arguments were in fact disingenuous. The continued commitment to Bretton Woods meant the limitations imposed by its provision of adjustment, liquidity and confidence remained, notwithstanding the one-time improvement in competitiveness that devaluation represented. Moreover, Britain was not on its own, but required the financial support of her allies. While this was readily available, it was on terms that did not necessarily put Britain first, but rather Bretton Woods.

Labour’s immediate objective was to secure a turnaround in the balance of payments and stabilise sterling, while also protecting living standards and maintaining a respectable rate of growth.

²⁰ Foreign Relations of the United States [FRUS] 1964 – 1968 Vol. VIII International Monetary and Trade Policy “Memorandum From the President’s Special Assistant (Rostow) to President Johnson” 19 October 1967

²¹ Scott Newton “The Sterling Devaluation of 1967, the International Economy and Post-War Social Democracy” *English Historical Review* Vol. CXXV No. 515 p 920 -925

²² Bale “Dynamics of a Non-Decision” p213

²³ Peter Gourevitch, *Politics in Hard Times: Comparative Responses to International Economic Crises* (Ithaca: Cornell University Press, 1986), p. 65.

However, the commitment to Bretton Woods and the opportunities presented by reform (see below) meant this had to be achieved without resorting to drastic measures like floating the currency and/or blocking the balances. Balancing these internal and external demands would require international support mediated via the IMF. In turn, this gave the IMF an interest in domestic economic policy, to ensure that (according to its analysis) domestic policy supported external objectives.

Both Labour and IMF agreed that there needed to be some movement of resources into the export sector. Disagreement arose over how much needed to be cut from domestic expenditure to secure a balance of payments surplus. Following his announcement of devaluation, Callaghan introduced requests on banks to reduce lending, reductions in defence expenditure and capital investment in nationalised industries of £200m.²⁴ However, Leslie O'Brien, Governor of the Bank of England, believed these measures to be much too small and unlikely to impress the IMF, recommending increases in income tax, in addition to greater cuts in public expenditure.²⁵ Although a \$1.4bn package with the IMF was rapidly arranged, the exact relationship between the IMF's money and government policy provoked debate, both contemporary and historical.

As part of the standby, the British were committed to drafting a Letter of Intent outlining which measures they were taking to ensure devaluation was a success, based on discussions with an IMF mission which had arrived in London. This has led some to believe the IMF extracted meaningful conditions in return for the money. Samuel Brittan considers the IMF mission and the need to draft a Letter of Intent brought home to Wilson and parliament that IMF money was not without strings and that greater action was needed to free up resources and make devaluation a success.²⁶ Michael Stewart notes that the left wing of Labour were disappointed that the need to secure IMF money involved public spending cuts when devaluation had finally freed the government of the obligation

²⁴ TNA PREM 13/1447 "Statement by the Chancellor of the Exchequer" 18 November 1967

²⁵ TNA PREM 13/1447 "Letter from Leslie O'Brien to the Chancellor" 17 November 1967

²⁶ Brittan *Steering the Economy* p377

to defend the sterling parity.²⁷ Catherine Schenk considers that the IMF played a “hard game” and “pushed the British government beyond their initial intentions.”²⁸

However, it is also worth noting that devaluation locked Britain and the IMF into a symbiotic relationship, given the joint commitment to defence of Bretton Woods. As Hamilton has noted, the change in parity did not in itself constitute a major break in the Bretton Woods system of adjustment, being permitted under the IMF’s rules in cases of ‘fundamental disequilibrium.’²⁹ Yet the result of sterling’s devaluation was a systemic crisis that engulfed Bretton Woods as markets speculated on a change in the price of gold (as a means of shorting the dollar) and on a second sterling devaluation. Within the context of a widespread fear of a return to the protectionism of the 1930s, the threat that a second sterling devaluation would result in controls on trade and payments as well as involve blocking the sterling balances moderated the IMF’s line regarding conditionality. In short, the IMF needed devaluation to work as much as Britain did and could be relied upon to support it on easy terms. Despite the leader of the IMF mission Richard Goode making it clear he was under pressure from Washington to have conditions attached to the aid, the British stubbornly resisted anything that seemed like untoward intrusion in their ability to make domestic policy as they saw fit.³⁰ This was in contrast to 1976 when sterling crises could be much more effectively contained thanks to wider reform to adjustment and liquidity that protected the dollar. Therefore, while the IMF’s money and ‘seal of approval’ were as important as they would be later, in 1967 the Fund could be relied upon to provide the money without insisting on too many demands.

This was supported by the attitude of the American government under President Johnson, which likewise remained committed to Bretton Woods. Like sterling, the dollar was a weak currency as external deficits undermined confidence. Both countries were interested in reforms to adjustment that would bring pressure to bear on surplus economies as well as deficit ones. In the short term,

²⁷ Stewart *Politics & Economic Policy in the UK since 1964* p85

²⁸ Schenk *Decline of Sterling* p198

²⁹ Arran Hamilton “Beyond the Sterling Devaluation” pp.73-75

³⁰ TNA PREM 13/1447 "Letter from Leslie O'Brien to the Chancellor" 17 November 1967

they collaborated to pressure countries with stronger currencies like Germany and Japan to revalue, thus improving the competitive position of sterling and the dollar.³¹ This ensured a sympathetic source of pressure on the IMF when securing financial support for sterling, again in contrast to 1976, when the US government was openly critical of British economic policies.³²

The lack of meaningful conditions is made clear by comparing the argument over public borrowing. A major topic of concern for the IMF was the government's Public Sector Borrowing Requirement [PSBR], which in 1976 proved a major clashing point. In 1967 however the British could easily dismiss a suggestion that the ceiling be put on the level of borrowing as "obviously politically impossible."

The IMF pushed for a commitment to cut public borrowing to a fixed amount should current policies be inadequate to restore the balance of payments surplus, another point that the British conceded (indeed proposed) in 1976 as a means of moderating immediate cuts.³³ In 1967 however they proposed a more relaxed approach, suggesting instead to update the Fund "from time to time, giving them our assessment of the situation and whether any further measures are called for."³⁴

A similar approach was taken with regards to control of credit. The IMF was concerned over the ability of the government to finance its borrowing via the banking system, provoking a contemptuous response from the Treasury. According to one official, "Richard Goode.... has rather too many bees in his bonnet - particularly on control of credit in the public sector," noting the IMF wanted to apply monetary principles "perfectly alright for the Argentine or a lesser-developed African country," but completely inappropriate for Britain's "sophisticated monetary system."³⁵

Despite mounting speculating in the press and in the House that the IMF would impose strict conditions in return for the money, the reality was that the British deftly handled the IMF's

³¹ Schenk *The Decline of Sterling* p204

³² Glen O' Hara "The Limits of US Power: Transatlantic Financial Diplomacy under the Johnson and Wilson Administrations, October 1964–November 1968" *Contemporary European History* (2003) Vol. 12 (3) p 260

³³ TNA T328/92 "Draft Letter of Intent" 20 November 1967

³⁴ TNA T328/92 "Outline of Draft Letter of Intent" 19 November 1967

³⁵ TNA T328/92 "Letter from D. F. Hubback to E. W. Maude" 24 November 1967; TNA T328/92 "Note on Memorandum of Understanding on the Borrowing Requirement. Hubback to Maude" 24 November 1967

objections to its policy mix and minimised the degree of conditionality attached to the support.³⁶ A nominal commitment to reducing the borrowing requirement to £1bn was presented to parliament as an “estimate on how policy would evolve,” and did not constitute a ceiling on government borrowing.³⁷ Following the new Chancellor Roy Jenkins’ statement on the matter on 30 November, his opposite number on the Conservative benches Ian Macleod concurred in this view: “we recognise that there are nothing so crude as conditions attached to this,” to which Jenkins replied: “in spite of misleading reports to contrary, the Fund has not attached conditions to this credit.”³⁸ The IMF board considered the standby on 29 November, making it both the quickest ever negotiated as well as the largest.³⁹ As Harold James has noted, the ease with which Britain secured funding aroused the ire of other countries, particularly less developed countries which were subject to much greater conditionality.⁴⁰

The reality was that unlike those countries Britain was systemically important enough for easy credit to be in the interest of the wider international community – too big to fail in today’s parlance. Despite a gruelling six hour briefing in front of the OECD’s committee on monetary reform (Working Party No.3) on the 30th, during which the British delegation came under a “barrage of questioning,” this view was ultimately endorsed.⁴¹ Britain defended its right to raise its public borrowing that might result from an increase in investment in the nationalised industries, which in other countries would entail private companies raising money directly from the markets and would not show up on the government’s balance sheet.⁴² In addition to the IMF money, the world’s major central banks,

³⁶ *Financial Times* 25 November 1967; TNA T328/92 “Telegram from UK Director of IMF to Foreign Office” 27 November 1967

³⁷ TNA T328/92 “Publication of Letter of Intent” 30 November 1967

³⁸ Hansard HC Deb 05 December 1967 Vol. 755 c. 1175

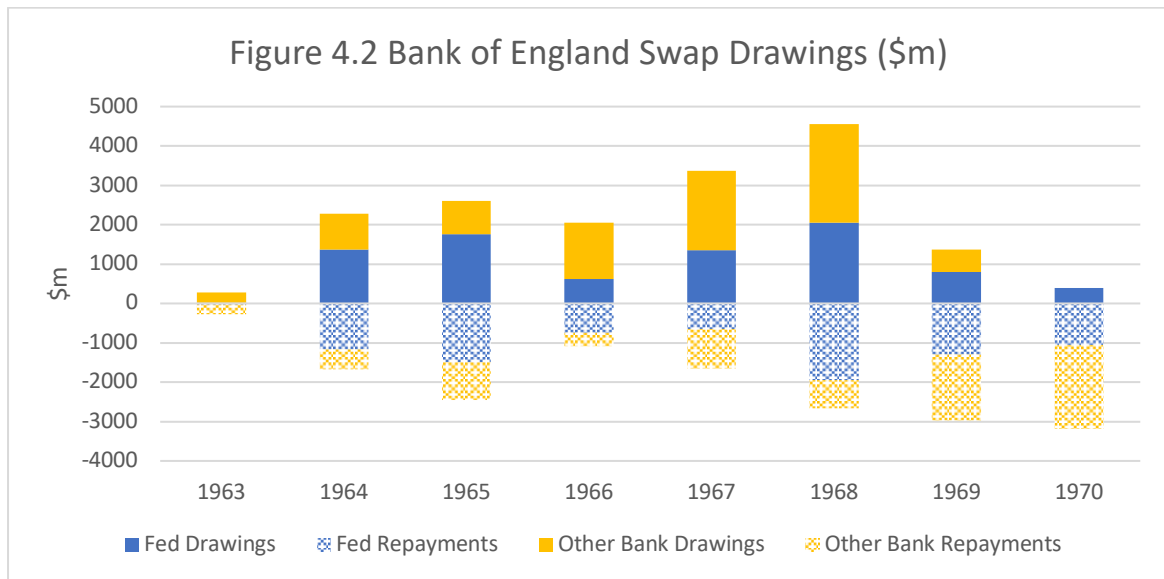
³⁹ Margaret de Vries *The International Monetary Fund 1966-1971 The System Under Stress Vol.1* (Washington DC: IMF, 1979) p343

⁴⁰ James *International Monetary Cooperation* p190

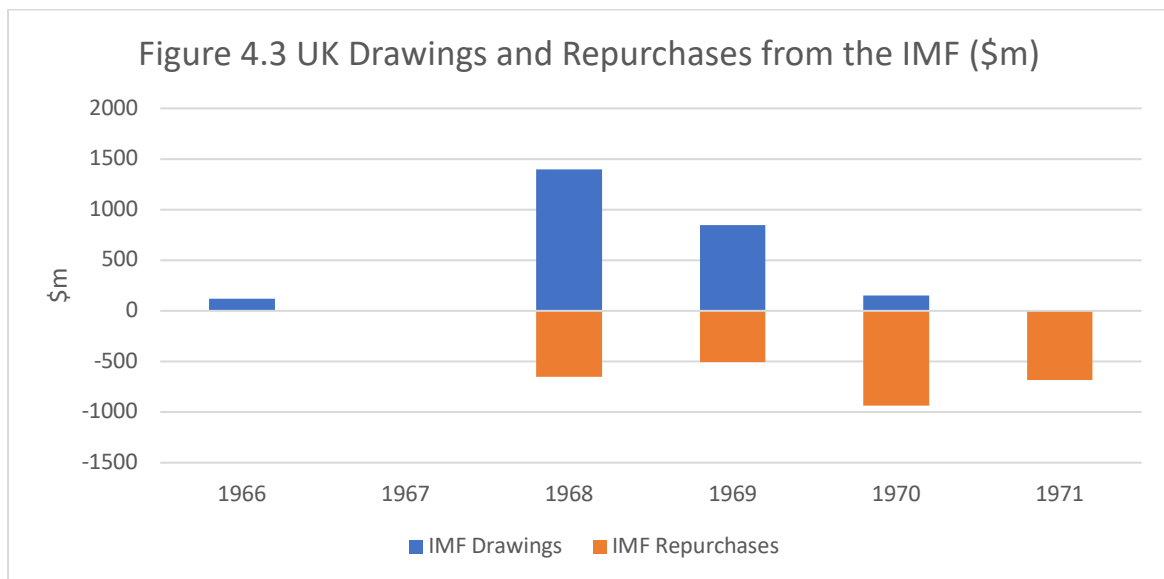
⁴¹ *Financial Times* 30 November 1967

⁴² TNA T328/92 “WP3 Introductory Speaking Notes for Sir Denis Rickett” 28 November 1967

operating through the Bank of International Settlements in Basle put a further \$1.5bn at Britain's disposal at the end of November.⁴³



Source: International Monetary Fund, *1971 Annual Report* (Washington D.C: IMF, 1971) p30



Source: Margaret de Vries, *The International Monetary Fund 1966-1971 The System Under Stress Vol. 1 Narrative* (Washington DC: IMF, 1976) p330

As figures 4.2 and 4.3 demonstrate, the threat that a sterling crisis might escalate into one that could bring down the entire Bretton Woods system meant support to ensure the defence of the post

⁴³ Toniolo *Central Bank Cooperation at the BIS* p399

devaluation parity was forthcoming on easy terms. Such an interpretation was later endorsed by the Fund's Managing Director, Pierre-Paul Schweitzer. Although he claimed, "the Fund always observed the principle that those policies and practices must be applied to all members in an impartial manner," he nevertheless recognised that Britain constituted a special case, a "situation of extraordinary importance," which, if left unresolved threatened to undermine the entire Bretton Woods system.⁴⁴

In summary, Labour was able to secure financial support for devaluation on more generous terms that would be available to other currencies due to the systematic importance of sterling to the world's monetary system. The true cost was in a renewed commitment, even stronger than made in 1964, to rule out adjustment using the exchange rate. To do so, it was feared, would be to provoke the collapse of the Bretton Woods system and with it the prospect of export-led growth. As such, adjustment was sought in alternative ways.

4.3: Government Expenditure Debates November 1967 – April 1968

The change in parity restored competitiveness to sterling, but this was not enough to bring about a surplus in the current account and stability in the currency markets. In the short run, the devaluation worsened the current account by making standing orders for imports more expensive and those for exports cheaper. This process was christened the J-curve as the current account deficit initially deteriorated before eventually improving (in the shape of a J).⁴⁵ According to the Keynesian absorption approach to the balance of payments developed in the 1950s, under a full employment economy there had to be some reduction in domestic demand to free up resources going into exports.⁴⁶ Thus although devaluation meant excessive deflation required to defend the old rate had been avoided, there was nothing automatic about the return to surplus and stability.

⁴⁴ TNA T328/92 "Managing Director's Statement on UK Stand By Agreement" 29 November 1969

⁴⁵ Anthony G. Webber "International Exchange Rate Movements and their Effects on Prices, Balance of Payments, Output and Employment" in Amnon Levy (ed.) *Handbook on the Globalization of the World Economy* (Cheltenham: Edward Elgar, 1998) p535

⁴⁶ Thirlwall & Gibson *Balance of Payments* p152

Britain had, for the most part, resisted the IMF's attempts to impose conditionality or oversight to the standby agreed at the end of 1967. However, the government recognised the need to free up resources to move into the export sector. As we have seen, O'Brien had criticised the domestic measures accompanying devaluation as insufficient to restore confidence. On 16 January 1968, as well as announcing the decision to accelerate the withdrawal east of Suez (see below), Wilson also unveiled a round of further expenditure cuts, including such items of totemic importance to the Labour party as the reintroduction of prescription charges and the postponement of raising the school leaving age to 16.⁴⁷ It was not enough. In anticipation of further increases in taxation to be announced later that year, a consumer boom had emerged as shoppers attempted to "beat the budget." Shortly after taking helm at the Treasury, Callaghan's successor Roy Jenkins had defended the decision not to move more decisively on restricting domestic consumption. "We do not want to dig a hole and leave it empty. We want it to be there only when export demand is ready to fill it." This, he later admitted, had been a mistake.⁴⁸ Jenkins did however bring forward his budget from April to March in response to the febrile atmosphere of an international crisis in the gold market (see below). The result was a decisive end to the boom, the Chancellor delivered the most deflationary budget since the war, increasing taxation by £923 million.⁴⁹

Simultaneously, Labour took the momentous decision to accelerate the withdrawal of Britain's military commitments in South East Asia – the so-called 'east of Suez' bases. Although the Suez Canal itself had long since fallen from British influence, the ongoing presence in the region was valued by the United States as contributing to holding back Communist incursion. Nevertheless, in the post-devaluation re-appraisal of Britain's place in the world, it was decided that this role could no longer

⁴⁷ Stewart, *Politics and Economic Policy in the UK Since 1964* p88

⁴⁸ *The Times* 13 March 1968; at the time Jenkins had defended the decision not to deflate the economy in 1967 but subsequently came to view it as "dangerous nonsense", see Roy Jenkins *A Life at the Centre* (London: Papermac, 1994) pp. 352 - 353

⁴⁹ *The Times* 20 March 1968

be afforded. The withdrawal demonstrated a decisiveness on the part of Labour, showing that they could move against American interests, albeit within the context of the defence of Bretton Woods.

The military commitment was a major cause of Britain's external deficits and hence sterling's instability. As Jim Tomlinson has argued, throughout the Wilson period the private sector comfortably paid its way in the world but the overall external account was dragged into deficit by government overseas spending, of which the military presence was the most notable expense.⁵⁰ Reducing these commitments seemed an obvious economy to make within the post-devaluation round of government spending cuts but this decision was complicated by the relationship with the Americans. They had previously constituted an important source of leverage over a United States increasingly anxious about the 'Domino Theory' of communist incursion and which feared losing the region. A widely held view was that some form of quid pro quo had been established in which Britain would maintain its east of Suez presence in return for American financial support. D. B. Kunz has asserted that support for the sterling throughout the 1960s was tied to the maintenance of these commitments, but Saki Dockrill has shown that the link was never formalised, as the Americans feared assuming responsibility for all of sterling's liabilities if they pressed too hard on the defence-sterling link.⁵¹

As Dean had noted in his New Year's message, Washington was hoping for a British presence east of Suez until the mid-70s, by which time it was anticipated the Vietnam war would have been won.⁵² However, British and American security interests had diverged. Following the end of the Malayan 'Emergency' (like Vietnam, never officially a war), there was less need for a military presence in Malaysia and Indonesia, while the threat to sterling because of these commitments had increased.⁵³

⁵⁰ Jim Tomlinson *The Labour Governments 1964- 1970 Vol. 3 Economic Policy* (Manchester: Manchester University Press, 2004) p14

⁵¹ D.B. Kunz, 'Somewhat mixed up together: Anglo-American Defence and Financial Policy during the 1960s', *Journal of Imperial and Commonwealth History*, (1999) Vol. 27, (2) pp.213-232; Saki Dockrill *Britain's Retreat East of Suez The Choice Between Britain and the World?* (Basingstoke: Palgrave, 2002) pp. 120 -121

⁵² TNA PREM 13/3551 Telegram from Washington to Foreign Office 004" 01 January 1968

⁵³ Dockrill *Britain's Retreat East of Suez* p121

In the summer of 1967, a defence review had planned a timetable for withdrawal whereby it was anticipated that the British presence would be halved by 1971, followed by full withdrawal in 1976.⁵⁴ However, the need to secure sterling following devaluation meant this timetable was accelerated. On the 4 January 1968 the decision was taken to complete the withdrawal by the end of 1971, with the Cabinet giving its assent to the idea that "our standing in the world depended on the soundness of our economy and not on our worldwide military presence."⁵⁵ Announcing the decision to the public later that month, the new Chancellor Roy Jenkins argued the decision would

cut us free of one of the most crippling legacies of our past – the attempt to maintain great power status on the basis of a medium power economy.⁵⁶

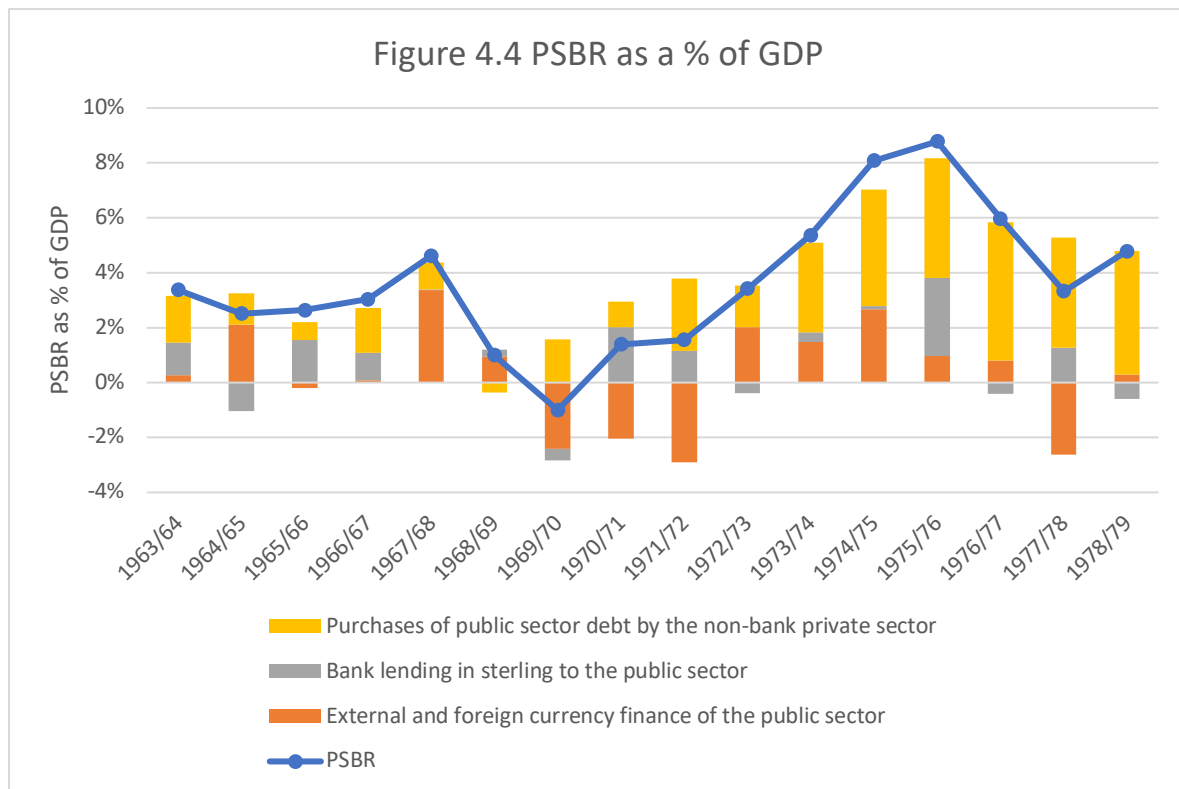
As Figure 4.4 shows, collectively the measures resulted in a more significant shift in public borrowing relative to GDP than occurred during the contentious IMF debates in 1976, involving a more extensive reduction in dependence on foreign borrowing, albeit from a lower base and at a time of growth in the global economy. This demonstrates the commitment of Labour to securing success in its post-devaluation strategy of export-led growth within a reformed Bretton Woods. It also however demonstrates the severity of the constraint imposed by the commitment to Bretton Woods provisions given that in other fundamentals, affecting sterling's creditworthiness such as control of the money supply and inflation, Britain's performance was better during this time than later.⁵⁷ It therefore placed a heavy burden on economic diplomacy to secure a lasting improvement in Britain's external relationship with the international monetary system, notably the sterling balances.

⁵⁴ John Darwin *The Empire Project The Rise and Fall of the British World System 1830 - 1970* (Cambridge: Cambridge University Press, 2011) p645

⁵⁵ TNA CAB 128/43 "Conclusions of a Meeting" 4 January 1968

⁵⁶ *The Times* 01 October 1967

⁵⁷ Luca Benati, "Evolving Post-World War II U.K. Economic Performance" *Journal of Money, Credit and Banking* (2004) Vol. 36 (4) p708



Source: Bank of England, Quarterly Bulletin 1984 Q4 "Funding the Public Sector Borrowing Requirement 1952-83"

4.4: Anglo-American Relations November 1967 – April 1968

The decision to withdraw militarily east of Suez has generally been taken as a turning point in the so-called 'special relationship' between Britain and America.⁵⁸ This interpretation however overlooks a strong commonality of interest between the two powers in seeking to defend and reform Bretton Woods. Despite the occasionally frosty relationship between Wilson and President Johnson, cooperation over monetary reform was effectively compartmentalised from conflict over military burden sharing. Although support for sterling in the post-devaluation period was mediated through

⁵⁸ Roy argues that following the resolution of the Gold crisis in March 1968, the United States displayed "considerably less interest and sympathy" for sterling now that it could no longer be considered the dollar's first line of defence, see Rajarshi Roy "The battle of the Pound : the Political Economy of Anglo-American relations 1964-1968" (Unpublished PhD thesis, The London School of Economics and Political Science, 2000) " p322

international institutions like the IMF and BIS, the US remained the key source of support and influence.

In its defence of sterling therefore, Labour sought to align with the US as much as possible, highlighting their common identity as weak reserve currencies and mutual interest in liquidity and adjustment reform. The commitment of the US under the Johnson administration to a reformed Bretton Woods meant sterling's instability became a source of leverage. In the immediate aftermath of devaluation, Wilson talked up this interaction, noting in a telegram to Johnson that, providing the balance of payments could at last be restored to a sustainable surplus, Britain would continue to maintain her military presence in Europe.⁵⁹ Wilson also argued devaluation would provide for long term stability for Bretton Woods:

This misery of the abscess which breaks out, is temporarily healed, then breaks out again. Each of us has shrunk from having the tooth pulled out. But when we finally decided to do so, the feeling of relief is not simply an illusion. The removal of a certain poison from the system purges the whole system itself.⁶⁰

The initial American reaction to the east of Suez withdrawal was ambiguous. The Foreign Secretary George Brown returned from the US having been berated by Secretary of State Dean Rusk who had rhetorically demanded "act like Britain."⁶¹ Two diarists of the Labour government recall Johnson objecting to the policy, sending a telegram which, according to Tony Benn, "warned us in the strongest terms that this would be a catastrophic decision."⁶²

When Johnson and Wilson came face to face in February however, the issue appeared to have been dropped. The President was more concerned with Bretton Woods than the Far East, reading from a paper "in Rooseveltian terms" about the potential danger of the rise of protectionism in fostering

⁵⁹ TNA PREM 13/1447 "Telegram from Wilson to Johnson" 17 November 1967

⁶⁰ Schenk *The Decline of Sterling* p181

⁶¹ Dominic Sandbrook, *White Heat: A History of Britain in the Swinging Sixties 1964 – 1970* (London: Penguin, 2009) p509

⁶² Tony Benn *Office Without Power Diaries 1968 - 72* (London: Hutchinson, 1988) p17; Richard Crossman *The Diaries of a Cabinet Minister Vol. 2 Lord President of the Council and Leader of the House of Commons 1966 – 68* (London: Hamish Hamilton, 1976) p650

economic and political instability. Wilson disagreed with the contention that they were on the verge of a revival of inter-war protectionism but eagerly agreed with one idea: that since the pound and dollar were linked it was in America's self-interest to support sterling.⁶³ According to the British record of the meeting, Johnson made no attempt to discuss the decision to withdraw east of Suez. As Wilson confided to the Canadian Prime Minister (the next stop on his tour), the only time the east of Suez had come up during his stay in Washington was when a distinguished American baritone had sung "Road to Mandalay" at a White House dinner. Wilson had been at pains to stress Britain had left Mandalay some twenty years previously.⁶⁴ Perhaps because he felt he had let Wilson off the hook, Johnson subsequently made some negative comments about Wilson in an interview with *The Times*.⁶⁵

Disagreement also emerged over American policies to defend Bretton Woods. In a bid to restrict US capital outflow, Johnson announced a series of measures on New Year's Day which restricted foreign investment and lending by American corporations and banks, while appealing to ordinary Americans to avoid non-essential travel abroad.⁶⁶ This policy was somewhat unwelcome to the British. Although Under Secretary of State Nick Katzenbach stressed the preferential treatment for the UK, by permitting 65% of the level of capital transfers in 65/66, Wilson complained that the base year had been poorly chosen as America had made virtually no investment in the UK that year.⁶⁷ Despite Wilson's concerns over the American measures, they were designed to shore up confidence in the dollar. This commitment to Bretton Woods on the part of the Americans therefore implicitly supported the British strategy of adjusting to surplus within the stable, open, multilateral trading and monetary order it provided. It stands in stark contrast to the measures unveiled by Nixon in

⁶³ TNA PREM 13/2455 "Record of a Conversation between the PM and the President at the White House" 08 February 1968

⁶⁴ TNA PREM 13/3551 "Record of a Meeting between the Prime Minister and the PM of Canada" 10 February 1968

⁶⁵ TNA FCO 7/857 "Heren's Article in The Times of 23 February" 24 February 1968; *The Times* 24 February 1968

⁶⁶ *The Times* 02 January 1968

⁶⁷ TNA FCO 59/194 "Note of a Meeting" 02 January 1968; TNA FCO 59/194 "Record of an Informal Discussion Between the Prime Minister and Under Secretary Nicholas Katzenbach at Chequers" 06 January 1968

August 1971, notably the 10% import surcharge and the breaking of the gold-dollar convertibility which fatally undermined the monetary system, if not the liberal trading order that had developed alongside it. Therefore, notwithstanding the disagreements between London and Washington over their respective New Year measures, this joint commitment to Bretton Woods provided the basis for ongoing cooperation, particularly with regards to its reform. This is of key importance in understanding the ongoing British commitment to Bretton Woods, since it was felt that only within the context of a generalised reform to the system's provision liquidity (backed by American influence and resources) would Britain be able to deal with the problem caused the sterling balances.

4.5: Liquidity Reform and the March 1968 Gold Crisis

Although sterling was stabilised following devaluation by the IMF money and subsequent spending measures, a new crisis soon destabilised the currency in the first months of 1968. Although centred on the dollar's relationship to gold (hence becoming known as the Gold Crisis), sterling was directly involved as markets bet on a second devaluation. The crisis and the ongoing debate over liquidity reform in which it took place demonstrated the extent to which stability of sterling was inherently linked to the stability of the wider monetary system. However direction of influence could run both ways. While sterling was impacted by events largely outside the control of policymakers in London (as speculators bet that the official dollar-gold price would soon be changed), in which commitment to the new sterling parity constrained policy, the danger of a second devaluation meant further short term support was available on easy terms from an American administration similarly committed to defending Bretton Woods.

Before analysing the Gold Crisis, it is important to situate it within the context of the ongoing debate over liquidity reform. International monetary diplomacy since the mid-1960s had been attempting to defuse the ticking time bomb of an increasingly untenable official gold price of \$35. Progress was accelerated in response to the crisis of March 1968. This debate, which continued over the entire period of this thesis, centred on the role of gold in international payments. It was one in which

Britain had direct interest given sterling's role in the monetary system yet struggled to make an impact. Nevertheless, it is important to understand given that how changes in the world's monetary system over the next ten years directly impacted the British ability to negotiate the external constraint.

Concerns over a looming liquidity shortage had been growing since 1965 as private demand for gold grew, putting pressure on the official price and the resources of the gold pool cartel set up to manage it. Growth in foreign exchange reserves also slowed down.⁶⁸ In response, Johnson announced in 1966 that he wanted to achieve reform to liquidity before the IMF Annual Meeting in September 1967.⁶⁹ The French took the role of America's principal antagonists and interlocutors in demanding a return to a system more fully based on gold. This reflected both the French preference for the metal as well as the suspicion that the dollar based system gave the US an unfair advantage.⁷⁰ In response to concerns about a growing liquidity shortage, they argued liquidity could be increased through a revaluation of gold's official price (while incidentally benefiting their sizable holdings).⁷¹ Although some doubts were being expressed privately in Washington about the wisdom of resorting to excessive measures domestically to supply the French with gold at \$35 per ounce, the official American line opposed a rise in the gold price, declaring it in January 1968 as "completely unacceptable."⁷² The US wished to phase out gold for official monetary payments, viewing the commitment to honour officially held dollars for gold as a constraint on their own monetary policy, and feared that while it would take some pressure off the dollar in the short term, merely raising the price would ultimately entrench its role.

For Britain, a major reason for the commitment to Bretton Woods and the constraint this imposed on sterling policy was the prospect of international reform that would alleviate sterling from the

⁶⁸ de Vries *System Under Stress* p401

⁶⁹ TNA T312/1735 "Memo from J. M. Stevens to Sir William Armstrong" 08 February 1967

⁷⁰ Harold James *International Monetary Cooperation* p169

⁷¹ Christopher S. Chivvis "Charles de Gaulle, Jacques Rueff and French International Monetary Policy under Bretton Woods" *Journal of Contemporary History* (2006) Vol. 41 (4) p718

⁷² TNA FCO 59/176 "Raising Gold Price Unacceptable to US" 12 January 1967; Roy *Battle of the Pound* p292

burden of its international role. In a reiteration of Keynes' proposals in 1944 for an International Clearing Union, the British advocated a new reserve unit, issued by the IMF which would be available to countries unconditionally while also directly transferable between central banks (to avoid political interference from the Fund). This however was unacceptable to the French who viewed the proposal as an attempt by deficit economies to more easily appropriate the savings of surplus ones. In response they proposed a much more limited and conditional form of 'drawing rights' on the Fund's existing resources. Summing up the differences and implications for domestic policy, one Treasury paper noted:

A Drawing Right is inevitably regarded as a right to incur a liability... a sense of being beholden to an outside institution remains and must produce a different mental attitude from that of someone who has spent an asset. The spender of the asset may be resolved to recover his asset again, in the same way as he would be resolved to pay off a drawing, but he would remain his own master meanwhile.⁷³

A recurring theme of these debates was however the moderation of British influence in an attempt to conserve political capital for other ends. At the time of this initial debate in March 1967, Britain's second application to join the EEC meant advocacy for a new reserve unit could not be pushed too far without jeopardising the relationship with the French upon which the (ultimately doomed) application depended.⁷⁴ The Americans however, also in favour of a reserve unit, lobbied hard those members of the EEC it perceived as sympathetic.⁷⁵ At a meeting of EEC deputies in April 1967, the Dutch, Germans and Italians came out in favour of a radical form of drawing right, similar in all main respects to the unit (in that it was unconditional and directly transferable), but the French remained adamantly opposed.⁷⁶ In compromise, the official European line settled on proposing new automatic drawing rights, albeit with tightened conditions and a European veto over their activation.⁷⁷

⁷³ TNA T312/1749 "International Liquidity Negotiations Unit V. Drawing Rights" 16 March 1967

⁷⁴ *The Times* 24 April 1967; Newton "Sterling Bretton Woods and Social Democracy" p448

⁷⁵ FRUS 1964 – 1968 Vol. 8 "Letter From Secretary of the Treasury Fowler to the German Minister of Finance (Schiller)" 06 April 1967

⁷⁶ TNA T312/1749 "Meeting of Group of Ten Deputies at The Hague." 14 April 1967

⁷⁷ de Vries *System Under Stress* p144

At meetings in May and June of the leading industrialised economies – the Group of Ten [G10] - agreement was reached that the new reserve facility would be based on a gold value guarantee and earn interest while the amounts created would depend on the IMF Managing Director's assessment of the world's need for liquidity over five year periods.⁷⁸ The language involved a delicate compromise with the final unit known as Special Drawing Rights [SDRs], aiming to act as a "supplement to existing reserve assets" rather than as a replacement for them.⁷⁹ One particular sticking point was "reconstitution" – how long rights could be drawn upon before being repaid. The French were insistent on this point since, in their view, the new unit was a credit not a reserve, while the Americans correctly feared that placing restrictions on the new asset would prevent its use. A compromise was reached in which participants agreed that over the first five year period participants would not draw more than 70% of its allocation.⁸⁰ At French insistence, issuance of SDRs would require the support of 85% of the Fund's voting power, giving the EEC an effective veto.⁸¹ The resolution for SDRs was agreed in September at the Fund's 1967 Annual Meeting in Rio de Janeiro which requested the Fund's staff to propose the amendments to the Fund's articles that would provide for the new facility. However, disagreement remained, with Callaghan and Henry Fowler, the US Secretary of the Treasury announcing their intention to treat SDRs as "front line reserves" while the French representative Debre argued they only amounted to an extension of the Fund's line of credit.⁸²

Thus at the same time as Britain was descending into the 1967 devaluation crisis, meaningful progress was being made on reforms with the potential to alleviate the sterling balance problem. This justified the post-devaluation commitment to Bretton Woods. However devaluation itself also intensified concerns over liquidity as speculators began to bet against the dollar through buying

⁷⁸ *Ibid* p151

⁷⁹ *Ibid* p155

⁸⁰ *Ibid* p158

⁸¹ Harold James *International Monetary Cooperation* p170

⁸² de Vries *System Under Stress* p159

gold, driving up the price and testing the commitment of the members of Gold Pool to its defence. Charles Coombs of the New York Fed had previously described sterling and gold as “twin time bombs: if one exploded, the other would explode as well.”⁸³ Demand for gold had been so high during and immediately after the sterling crisis in November 1967 that the Fed was forced to airlift gold into London to maintain the price at \$35 per ounce.⁸⁴ The Americans remained committed to the Gold Pool, whereby leading central banks cooperatively intervened in the gold markets to manage the price, as a vital defence of Bretton Woods. On 24 November, the Chairman of the Fed William McChesney Martin phoned O’Brien requesting the British put out a declaration defending the official price. Jenkins understood that it would be American support that would keep Britain afloat during the crucial transitional period while her balance of payments moved into surplus but was wary of appearing as America’s only supporter in the face of a hostile EEC (although this concern became somewhat academic three days later when De Gaulle vetoed Britain’s second application).⁸⁵ Further cajoling from Washington drew together a communique from the members of the Gold Pool in Frankfurt on 26 November.⁸⁶

By early December markets had calmed down but the Treasury remained concerned about the risk to sterling from a crisis in the gold markets. A much-circulated paper “Gold and the Dollar” proposed that the underlying instability of the Bretton Woods system in recent years lay not in the balance of payments difficulties of any particular country but in a systemic imbalance between “one half of the world’s economy and the other,” which the world’s monetary system in its existing form was unable to correct. According to this thesis, the continental Europeans and their apparently perpetual surpluses were as much to blame as Britain and the US for monetary instability.⁸⁷

⁸³ Federal Reserve "Memorandum of Discussion" 27 November 1967
<http://www.federalreserve.gov/monetarypolicy/files/fomcmmod19671127.pdf> [Accessed 12/03/2013]

⁸⁴ "Federal Reserve "Memorandum of Discussion" 27 November 1967
<http://www.federalreserve.gov/monetarypolicy/files/fomcmmod19671127.pdf> [Accessed 12/03/2013]

⁸⁵ TNA T312/2043 "Note for the Record" 24 November 1967

⁸⁶ FRUS 64/68 Vol. 8 "Memorandum From the President's Special Assistant (Rostow) to President Johnson" 26 November 1967

⁸⁷ TNA T230/997 "Gold and the Dollar" 27 November 1967

Given the dollar's privileged position within Bretton Woods as the only currency linked to gold, speculating on a rise in the price of gold was the main means of shorting the dollar. A break between the two was therefore the most likely outcome of America failing to restore its external account to surplus and/or reform of Bretton Wood's provisions on adjustment and liquidity. The Treasury paper was candidly open about how little influence Britain would have over the outcome of a break between gold and the dollar. "A good deal would depend on whether we were in the Common market or not," the paper concluded, expecting that Britain would be part of a gold based bloc likely to appreciate against the dollar if in, while finding themselves under American "power and influence with a dollar standard" if not.⁸⁸

The British position was complicated by the existence of large, gold guaranteed debts to the IMF. As one Treasury paper noted, rather than profiting from a rise in its gold holdings (as France would), Britain would be at risk of a large increase in its liabilities.⁸⁹ With this in mind, O'Brien had responded to Martin's request for Britain to further increase its commitment to the Gold Pool by sounding out if the Americans would be prepared to support the British in respect of her gold guaranteed liabilities should the gold price of the dollar be raised – something that was then commonly expected to be by as much as 100%. After forwarding the request on to Fowler, the US Treasury Secretary stated he could not recognise it since he "could not admit such a possibility" as a change in the price of gold.⁹⁰ Ultimately the precariousness of the British situation and the uncertainty of what support would be forthcoming in event of a rupture imposed a conservatism on the British outlook and an inclination to maintain as much of the present system as possible in the short term, while working towards progress on monetary reform in the medium term.⁹¹

Speculation in gold markets was given added impetus by the comments of leading officials. Otmar Emminger of the German Bundesbank questioned the wisdom of providing gold to speculators at

⁸⁸ TNA T230/997 "Gold and the Dollar" 27 November 1967

⁸⁹ TNA T312/2043 "International Liquidity Gold - A Possible Line of Action" 18 December 1967

⁹⁰ TNA PREM 13/2051 "Note for the Record" 16 December 1967

⁹¹ TNA T312/2044 "Gold and the Dollar" 05 February 1968

artificially low rates and waxed lyrical at a speech in February 1968 on the prospective diminution of gold's role in the system from the "sovereign of sovereigns" to a mere "constitutional monarch."⁹²

Shortly after this speech, the US Senator Howard Jarvis called for an end to gold convertibility and profligate government spending, a comment which sparked heavy buying in the gold market.⁹³

Within the Johnson administration itself, Fowler's advisory committee had already determined the solution to the crisis. Unanimously rejecting a rise in the price, they inclined rather to separate the private and public gold markets with the private price being determined by supply and demand while the public price would remain fixed at \$35 per ounce. It was hoped that the measures, combined with a stringent domestic tax hike, would buy time for the Americans to restore their monetary arrangements to a more sustainable footing.⁹⁴

On 8 March, while Fowler was meeting his advisory committee, the London gold market witnessed the heaviest demand for gold since the devaluation of sterling the previous November.⁹⁵ Although when he called on Martin on 13 March, O'Brien found the Americans apparently determined to go on as before, the following day Fowler called Jenkins and requested that the London gold market be closed the next day. A conference in Washington was hastily arranged to consider the international response to the crisis.⁹⁶

While the threat to the dollar could be contained through splitting the public and private gold markets, this would not solve sterling's now precarious position. By the time of the Washington conference the crisis had reached an acute stage for the British who faced the very real possibility that their reserves would be exhausted within a matter of days. A humiliating second devaluation

⁹² TNA T312/2043 "Note for the Record" 07 December 1967; TNA T312/2044 "The Role of Gold in Our Monetary System" 15 February 1968

⁹³ TNA T312/2139 "Jarvis Urges Steps to Strengthen Confidence in Dollar" 28 February 1968; TNA T312/2139 "Letter from Maude to Armstrong" 4 March 1968

⁹⁴ FRUS 64 -68 Vol. 8 "Memorandum From the President's Special Assistant (Rostow) to President Johnson" 08 March 1968

⁹⁵ *The Daily Telegraph* 08 March 1968

⁹⁶ TNA T312/2044 "Governor's Note" 13 March 1968; FRUS 64 – 68 Vol.8 "Memorandum From the President's Special Assistant (Rostow) to President Johnson" 14 March 1968

beckoned. Potentially they would not even be able to wait until an American decision to change the gold price, still the British expectation of American policy, demonstrating how despite their combined commitment to Bretton Woods, Anglo-American negotiations did not form the basis for policy formulation, limiting British influence. As a memo for the Prime Minister noted:

While it would be quite acceptable to act in unison with the dollar, a second sterling crisis before a dollar crisis would represent a political catastrophe of major proportions.⁹⁷

Later in the evening of 14 March, O'Brien called Martin to tell him that the British were prepared to declare the next day, a Friday, hence closing both the gold and exchange markets and taking the pressure off sterling. In return, the British wanted an American commitment to support sterling in the New York currency markets which would still be open. The alternative was to "let the rate go."⁹⁸ In return, Martin told his opposite number that the Americans were considering withdrawing from the Gold Pool and separating private and public gold markets.

Although not confident that the policy would be a success, Jenkins recognised that given the weakness of the British economy and sterling's reliance on American support meant the British negotiating team they had "little, if any" influence over the American decision to establish a two-tier gold market.⁹⁹ Contingency planning in the Treasury considered Britain's options if support for sterling was not forthcoming. Guarantees to sterling holders or blocking the sterling balances were considered but floating looked the most likely outcome. A pre-emptive float was ruled out in that it would undermine the forthcoming budget and because Britain lacked the resources to prevent the rate plummeting downwards.¹⁰⁰ The British were concerned that the Americans would be too preoccupied with the establishment of the dual market to pay much attention to sterling. As such, the only practical policy was to draw attention to the perilous position of sterling and the threat this

⁹⁷ TNA PREM 13/2051 "International Monetary Crisis" 14 March 1968

⁹⁸ TNA PREM 13/2051 "Note for the Record" 14 March 1968

⁹⁹ TNA CAB 128/46 "CC (68) 21st Conclusions" 15 March 1968

¹⁰⁰ TNA PREM 13/2051 "Contingency Planning" 16 March 1968

posed to Bretton Woods in the hope that this would prompt fresh international support to tide Britain over the crisis. The Treasury considered extending the Bank Holiday to the following Monday and Tuesday in the hope this would draw attention to the severity of sterling's plight to those in Washington with the resources to help.¹⁰¹ On the evening of 14 March, Wilson sent Johnson a telegram outlining the precariousness of sterling's position:

I fully recognise the need for you to take urgent action almost certainly tonight, not only in your interests but in ours and indeed of the world. What is important is that the action taken must be one which holds our two nations together. ...If in the interests of urgency and speed you take a decision which puts us at immediate risk it is vital that we are covered by you during the days immediately ahead. Otherwise both currencies will go. Alternatively, we would have to take urgent action to protect ourselves which could only have the effect of dumping the whole burden back on the dollar.¹⁰²

Meanwhile in Washington, the Permanent Secretary of the Treasury William Armstrong confirmed that the dual price system appeared to be "the only runner", but that the Governor of the Bank of England had succeeded in drawing attention to the special status of sterling at this critical juncture. Armstrong hoped to get an extra \$5bn of support on top of existing lines of credit and recommended backing the Americans' dual market system in return for such support.¹⁰³ After speaking to Armstrong the next day, Jenkins reported back to his Cabinet colleagues on the progress of the British delegation. Armstrong now reported that the likely amount of fresh support for sterling would be \$2.2bn, bringing total available credit including existing lines of support up to \$5bn. Later that day Armstrong told Jenkins negotiations were now at a crunch point and that total support would likely be \$1bn short of the \$5bn figure.¹⁰⁴ In the end, the British delegation was successful in only gaining new support of \$1.75bn, although when added to unused central bank facilities and IMF lines of credit it totalled a more press friendly figure of \$4bn.¹⁰⁵

¹⁰¹ *Ibid.*

¹⁰² TNA PREM 13/2051 "Telegram from Foreign Office to Washington" 14 March 1968

¹⁰³ TNA PREM 13/2051 Telegram from Armstrong to Chancellor No 925" 16 March 1968

¹⁰⁴ TNA PREM 13/2051 "Note for the Record" 17 March 1968

¹⁰⁵ *The Daily Telegraph* 18 March 1968

The significance of the gold crisis has been recently reappraised. Oliver and Hamilton describe the gold crisis having “the potential to be the most severe sterling debacle of the post-war era,” as Labour struggled with the implications of dwindling reserves and considered such extreme resorts as floating the currency, blocking the sterling balances and initiating a ‘siege economy’ involving extensive controls on trade and payments.¹⁰⁶ By March 1968 reserves were so low that serious consideration was given to a fundamental break with Bretton Woods.¹⁰⁷ However, as Newton argues, the danger that such a break with Bretton Woods would result in a return to conditions of the 1930s – protectionism, floating, competitive devaluations – meant Labour could use their contingency plans for blocking and floating sterling to secure support from the Washington conference held in response to the crisis.¹⁰⁸ This provided a short term inducement to retain the commitment to Bretton Woods while reforms to liquidity progressed.

While this strategy was successful as sterling navigated the gold crisis while maintaining the commitment to the post-devaluation parity, it did reveal the dependency of British sterling policy on the US, both for short term financial support and influence in monetary reform debates. While the revisionist approach praises the ability of Labour to leverage sterling’s weakness to secure international support, the danger of constantly talking up British weakness was that it might undermine the value of the Anglo-American relationship in American eyes. In a National Security Meeting concerning Anglo-American relations in May 1968, the Secretary of State for Defence noted “the UK does not have substance, backup, hardware or funds to face up to any big problem in the world.”¹⁰⁹ According to Roy, the gold crisis marked a turning point in the Anglo-American economic

¹⁰⁶ Oliver & Hamilton “Downhill from Devaluation” p490

¹⁰⁷ Hamilton “Beyond the Sterling Devaluation” pp. 83-84

¹⁰⁸ Newton “Sterling, Bretton Woods and Social Democracy” p442

¹⁰⁹ Quoted in Heide Irene Schmidt “Anglo-American Relations and International Monetary Policy, 1958-69” in Ursula Lehmkuhl & Gustav Schmidt [eds.] *From Enmity to Friendship Anglo America Relations in the 19th and 20th Century* (Augsburg: Wißner-Verlag, 2005), p199

relationship as the Americans became less concerned with sterling now it no longer constituted the “front line” defence of the dollar.¹¹⁰

Nevertheless, mutual interest as reserve currencies committed to the defence of Bretton Woods resulted in continued cooperation over international reform. This joint Anglo-American approach can be seen in the struggle to ratify the SDR, which for Americans considered the next step in monetary reform now that the separation of the gold market had bought time. In a ministerial meeting of the Group of Ten in Stockholm at the end of March, the British lined up with the Americans against the French in pushing for a large and early activation of SDR. According to Jenkins, the Stockholm meeting saw the French at their most obstinate, attacking the US’s lax monetary policy as the cause of the recent gold crisis and calling immediately for a rise in the price of gold. In a message to Wilson, Jenkins described Debre, the French Finance Minister as

Clearly determined at this stage to stand out on every point, even where he was totally without support: his interventions were frequent, often lengthy, sometimes brutally offensive, but always highly elegant and articulate.¹¹¹

Despite the French obstructionism, the delegates at Stockholm agreed to amend the main IMF articles to allow the issue of SDRs if and when the scheme was activated. Debre, who had spent most of the time criticising the proposals as contrary to the agreement reached the previous November in Rio (arguing it was a credit rather than asset), was placated in the communique by the concession that SDRs would be activated only after a collective judgement that “there was a global need to supplement reserves”¹¹²

The British and the Americans therefore maintained a cooperative and productive relationship in the field of international monetary reform, which enabled the British to present their demands for fresh support as a necessary part of achieving a more stable system. Activation of the SDR would, it was

¹¹⁰ Roy “The Battle for the Pound” p322

¹¹¹ TNA T312/2039 “Telegram for Prime Minister from Chancellor of the Exchequer” n.d.

¹¹² TNA PREM 13/3151 “ Telegram from Foreign Office to UK Director of IMF” 1 April 1968

hoped, provide the British with another source of finance with which to manage the problem of the sterling balances. Despite concern over the balance of payments in the short term, the outcome of the Stockholm conference permitted some optimism about the future of Bretton Woods in the medium term. These sentiments were shared in Washington where Johnson's adviser Rostow argued the outcome of the Washington conference and agreement in Stockholm constituted the "building blocks in the development of a stronger monetary system."¹¹³

Despite British attempts however there was little appetite for linking expansion of international liquidity with resolution of sterling's status as an international currency. The hope of the Wilson government was that the long-term prospects of Bretton Woods involved transitioning to a system based on SDR with gold becoming a subsidiary rather than a reserve asset. Wilson's advisor Nicholas Kaldor thought it possible that the IMF might become the monopoly buyer and seller of gold, gradually phasing it out as a means of international payments with SDRs becoming the exclusive means of settling trade imbalances. For Kaldor, this meant "we should gradually be able to escape from the burdens and dangers inherent in our reserve currency status."¹¹⁴

However, the objection of the French indicated the difficulty in using the SDR to effect a meaningful resolution to the sterling overhang. Against the background of disappointing trade figures, Jenkins met with his senior advisors to outline the prospects for the monetary system. Two possible outcomes were delineated. On the one hand, the American tax increase would cool down the overheating domestic economy, while a reduction in capital outflow would likewise help stabilise the overall American balance of payments. The dollar would strengthen and speculation over gold would lessen thus improving the prospects for Bretton Woods. Alternatively, a revival of speculation would see traders moving out of dollars and sterling and into gold and the stronger European currencies. This would not lead to immediate demonetisation of gold on the American part, rather a suspension

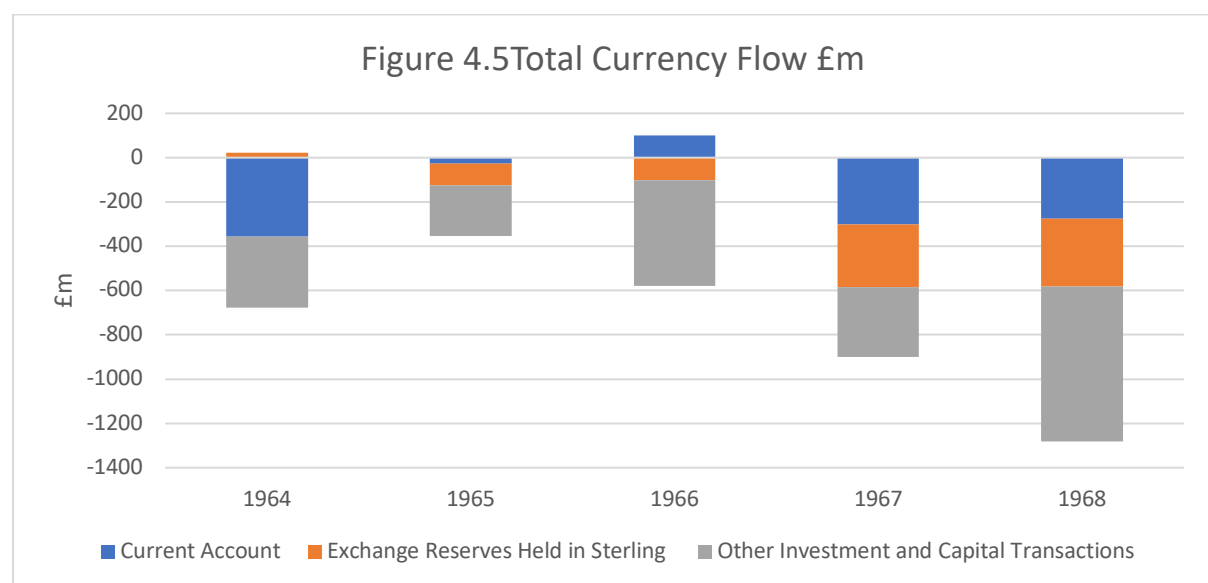
¹¹³ FRUS 1964 – 68 Vol. 8 "Memorandum From the President's Special Assistant (Rostow) to President Johnson" 02 April 1968

¹¹⁴ TNA T312/2139 "The Price of Gold" 02 April 1968

of gold sales. In this pessimistic (and ultimately correct) outcome the British would be in a position of gloomy impotence with the French, Germans and Americans determining the future course of Bretton Woods.¹¹⁵ Despite some progress, the uncertainty of Bretton Woods reform therefore meant the stability of sterling could not be assured in the short term.

4.6: The Second Group Arrangement *March 1968 – September 1968*

With the future availability of SDRs unclear given French opposition to activation, Britain was prompted to look for a specific solution tailored towards the holders of the sterling balances. As Figure 4.5 shows, reductions in reserves held in sterling contributed almost as much as the current account to Britain's deficit in 1967 and exceeded it in 1968 as sterling balance holders responded to devaluation and the weakening of defence links between Britain and the USA.



Source: Central Statistical Office *United Kingdom Balance of Payments 1964 – 1974* (London: HMSO, 1975) Table 1.3 "Analysis of Capital Transactions and Official Financing" p11

The result, as shown above in Figure 4.1, was a reduction in the level of balances held as exchange reserves by official monetary institutions. Given the later commitment of Labour government to end sterling's reserve role this would seem to be a step in the right direction. However, the prioritisation given to defending and reforming Bretton Woods meant that diversification threatened to

¹¹⁵ TNA T312/2139 "Note of a Meeting" 07 May 1968

undermine Britain's ability to maintain sterling's post-devaluation exchange rate peg. Britain therefore looked to secure a further support line tailored toward financing prospective diversification.

While a previous arrangement in 1966 had provided funding to enable sterling to deal with fluctuations arising from NSA holders, the Bank of England had been pushing for a more comprehensive package aimed at the members of the OSA. Accordingly, the Bank of England began discussions with the BIS at the beginning of 1968 about a medium-term financing facility to offset anticipated diversification by OSA holders.¹¹⁶ This approach was however rooted in the Bank of England's continued preference for maintaining sterling as a reserve currency. Fforde of the Bank believed the loan would help preserve sterling's role as a reserve currency and even made the case that sterling's international role could be beneficial in the context of the EEC, although conceded this was an "unfashionable" view.¹¹⁷

The Bank of England's approach was based on the belief that the BIS would prove more "accessible" and flexible in its provision of credit in support of the balances than the IMF. Following the Washington conference in March 1968 which formally separated the public and private gold markets, the Bank intensified efforts to come to an arrangement with the BIS on a medium-term credit. On 12 May, the Bank submitted proposals to the BIS requesting a \$2bn credit line which could be drawn in response to OSA diversification over the next three years, but this did not generate much enthusiasm in Basle. Instead, the European members required greater commitment from the Bank of England, in the form of guarantees on the exchange value of OSA sterling holdings that would also prevent diversification, rather than merely financing it.¹¹⁸

Exchange guarantees would involve the UK making payments to sterling holders if the value of sterling dropped below an agreed rate. Both the Bank and Treasury were unenthusiastic but

¹¹⁶ Toniolo *Central Bank Cooperation* p423

¹¹⁷ Cappie *Bank of England* p406

¹¹⁸ Schenk *The Decline of Sterling* p287

recognised that the strength of feeling among European central banks meant they were necessary to move forward with the scheme. Accordingly, the Bank of England offered a dollar guarantee on the value of OSA sterling holdings above 10% of their total reserves.¹¹⁹ The BIS also wanted the OSA countries themselves to contribute to the arrangement, since they after all would be the main beneficiaries of greater stability in the value of their exchange reserves. The OSA deposited some of their non-sterling reserves with the BIS to increase liquidity for the \$2bn facility for sterling (although as this was arranged through the BIS in the form of swap agreements with the world's leading central banks, they did not assume any risk). In addition, Britain committed to negotiating with the OSA members individually to establish the amount of sterling each member would hold as a proportion of their total of reserves – known as minimum sterling proportions [MSPs]. Together with the exchange guarantees, the MSPs reduced the likelihood of the facility being drawn on by providing powerful incentives for the OSA to keep their foreign exchange holdings in sterling rather than diversifying.¹²⁰

The Second Group Arrangement as it was formally known was approved in Basle in July 1968. As part of the deal, the British were committed to negotiate bilateral Sterling Agreements individually with members of the OSA. This took place over the summer towards the deadline of September. By then the Treasury had negotiated deals with 30 countries, which together constituted 77% of OSA holdings.¹²¹ These negotiations involved agreeing the level of MSP and the guaranteed exchange rate of sterling below which payments would be made from the UK Treasury.¹²² The level of MSP varied between holders, with colonies like Hong Kong committing to holding 99% of their reserves in sterling while India, which had already diversified significantly in the immediate post-war period, only committed to a 13% MSP.¹²³ Despite a last-minute decision by the Bank of France not to

¹¹⁹ *Ibid*, p287

¹²⁰ *Cappie Bank of England* p409

¹²¹ *Toniolo Central Bank Cooperation* p425

¹²² *Schenk The Decline of Sterling* p292

¹²³ *Ibid*. p295

participate, the second Sterling Group Arrangement was formally announced on 9 September 1968. In October, the Bank of England drew \$600m which turned out to be the only drawing ever made under the arrangement as the British balance of payments and prospects for sterling improved over 1969 (see below).

According to the BIS official historian Toniolo, the arrangement was as a success, marking an important contribution to currency stability.¹²⁴ Edmund Dell is less sure, noting that by guaranteeing the OSA the dollar value of their holdings while still paying out a higher interest rate than the dollar due to sterling's increased vulnerability, the arrangement proved an expensive commitment, one that led to an increase in sterling holdings rather than a decrease.¹²⁵ For Catherine Schenk, the Sterling Agreements marked a "drastic change in the organisation of the sterling area," transforming the relationship between Britain and the rest of the OSA from a "a voluntary association of states that had traditional economic and commercial ties to the UK to a formalised network of bilateral contracts between the UK and various members."¹²⁶ While incentives based on trade, finance and security eroded over the 1960, devaluation had provoked a "profound sense of betrayal" among the sterling balance holders whose holdings were now exposed to sterling's weakness. Now new inducements had to be explicitly issued in contracted form to prevent mass diversification before any further movement on the exchange rate.¹²⁷ In Susan Strange's taxonomy, Sterling had become a Negotiated Currency, its continued international use dependent on the incentives to do so on offer from the issuing state.

From the perspective of the 1976 IMF crisis, we can see that the generous terms on offer through the Second Group Arrangement began the process of a medium term build up in the sterling balances which, when subsequently exacerbated by post OPEC-shock oil producers depositing their

¹²⁴ Toniolo *Central Bank Cooperation* p425

¹²⁵ Edmund Dell *The Chancellors A History of The Chancellors of the Exchequer 1945 – 1990* (London: Harper Collins, 1996) p358

¹²⁶ Schenk "The Sterling Area and Economic Disintegration" pp.23-24

¹²⁷ Schenk *The Decline of Sterling* p313

earnings in sterling, provided a major driver of crisis in 1976. While both Britain and the wider international community were in favour of running down sterling's international role (particularly the prospective European partners who had no desire to assume sterling's liabilities), paradoxically they resisted any meaningful run down in the balances following devaluation.¹²⁸

Instead, prioritisation was given to defence of Bretton Woods, requiring inducements to holders in the form of high interest rates and exchange guarantees so attractive that they facilitated a renewed build-up in the levels held. While successful from the perspective of creditors, in that the most of the \$2bn credit was not in fact drawn upon, given the commitments made by the British, a more equitable and satisfactory outcome for sterling would have been to use some of the credit line to draw down the sterling balances.¹²⁹ While this would not have reduced sterling's liabilities it would have involved some transformation in structure from short to medium term while also preventing the build-up among more volatile holders. However, given the reluctance of creditors to see their money actually used, this would have involved a longer discussion and potentially more expensive commitments on the part of the British. Thus while the scheme helped secure confidence in sterling, it did not contribute to the liquidity problem of the sterling overhang. This contrasts with the 1977 Third Group Arrangement, which included a foreign currency bond offer to facilitate diversification and a commitment to prevent future accumulations which resulted in a reduction to working balances.

4.7: 1968 Exchange Crises *May 1968 – November 1968*

The position of sterling remained perilous throughout 1968 as the balance of payments stubbornly resisted efforts to transition to a surplus. This objective had been made harder to achieve due to the turmoil afflicting Bretton Woods, itself exacerbated by sterling's weakness. The Washington Conference and the Second Group Arrangement were ad hoc responses to this instability which, it

¹²⁸ Schenk "Sterling, International Monetary Reform and Britain's Applications to Join the European Economic Community in the 1960s" p357

¹²⁹ FRUS 64-68 Vol. 8 "Memorandum for the Record" 1 September 1968

was hoped would buy time for more permanent solutions (such as activation of SDRs) to come into effect. However, Bretton Woods' adjustment mechanism remained a source of instability, as revealed by a series of exchange crises in 1968 afflicting the franc and DM which also threatened the post-devaluation sterling parity. The cost of Britain's commitment to Bretton Woods was exposed by the inability of the system to effect adjustments without high political drama and consequent crisis on the exchanges. Having devalued sterling and committed to the defence of the new parity, British competitiveness could only be preserved and improved through the behaviour of other currencies. However this required political influence that Britain, dependent on the wider international community for financial support, simply did not have. As the exchange crises of 1968 demonstrated, they were unable to induce the Germans, French or Americans into their preferred choice of policy. The threat of a second devaluation was never far from policy makers' minds throughout 1968 while the external account remained stuck in deficit. A meeting between the US and British Treasuries in May in Bologna brought home the precarious nature of sterling. A phone call from Robert Roosa in New York informed Denis Rickett of the Treasury of a rumour circulating that the British were planning a fresh devaluation of 30%. With classic understatement, Rickett "naturally did no more than express mild surprise." Although it had no basis, as Rickett acknowledged the fact that someone of Roosa's experience and background could give credence to such rumours indicated the unstable nature of sterling during this period.¹³⁰ In June the government decided to draw the IMF standby of \$1400m made available the previous November to refinance short term debt owed to central banks.¹³¹

While sterling was coming under suspicion, events in France were taking an even more dramatic turn. A series of student protests and general strikes in May had plunged the French economy and political scene into crisis, even threatening revolution. In response, de Gaulle had conceded large

¹³⁰ TNA T312/2039 "Memo from S Goldman to Douglass Allen" 08 May 1968

¹³¹ TNA PREM 13/3151 "Foreign Office to UK Director of IMF" 05 June 1968

increases in wages, which the British Treasury estimated would plunge the French balance of payments into deficit to the tune of \$500m. Currency traders anticipated this by moving from francs into Deutschmarks.¹³²

This movement exposed the shortcomings of the Bretton Woods method of adjustment. The historic German fear of inflation meant that under fixed parities the Germans enjoyed an ever-increasing competitive advantage over other countries as the real value of their currencies eroded faster than the deutschmark. This resulted in enormous external surpluses. As well as resisting revaluation of their currency the Germans also resisted any increase in inflation, sterilising the impact of the capital inflow on the domestic money supply through selling domestic bonds.¹³³ These contradictions resulted in an exchange crisis at the end of 1968 as speculators took advantage of a one-way bet in which the Deutschmark could potentially be revalued but had no chance of being devalued.¹³⁴

These contradictions revealed the cost of Britain's commitment to Bretton Woods. Labour looked to the system to provide a stable external framework that would facilitate the trade upon which they relied for export led growth as well as for providing a solution to the long-term sterling balance problem. In return Britain received support for sterling but at the cost of a maintaining an exchange rate parity that required deflation at home and borrowing abroad. In the zero-sum game of competitiveness, revaluations or devaluations on the part of other economies could improve or worsen the position of sterling. The main problem was that such adjustments were inherently politicised under Bretton Woods, resulting in a cycle of crisis in which heavily publicised summits featuring the very heads of government attempted to negotiate new exchange rate parities, feeding the sense of uncertainty and provoking yet more speculation on the exchange markets. Britain's commitment to Bretton Woods meant it was trapped in this cycle, unable to float yet marked as a weak currency under constant threat from speculation.

¹³² Oliver & Hamilton "Downhill from Devaluation" p497

¹³³ Ibid p221

¹³⁴ TNA T312/2139 "Gold and the Dollar Contingency Planning" 03 May 1968

The farce of Bonn conference in November 1968 revealed the extent of the cost this commitment imposed on the British economy, as well the limits to British influence within an extremely politicised method of adjustment. The conference attempted a multilateral realignment of the franc and DM while preserving stability in the dollar and sterling. For sterling, speculation over the DM was immediately damaging by provoking speculation but if the result of the crisis was a revaluation this would ultimately improve competitiveness. The actual outcome was the worst of both worlds; a damaging exchange crisis in which Germany resisted revaluation.

Once again, the Labour government looked to leverage their commitment to Bretton Woods as a source of influence. Heide-Irene Schmidt considers that despite a wider American reappraisal of the British capabilities following the Suez decision, “the Fowler reflex” was to respond to British dramatizing of the crisis into a “life or death affair” for Bretton Woods as a whole.¹³⁵ O’Hara argues that the Americans, well aware of British contingency planning for further devaluation or floating, could not tolerate this and therefore went along with British pressure on the Germans and the French.¹³⁶ However, the inability of the Labour leadership to align their approach with the Americans and the subsequent failure of the conference to effect adjustment on either the French or Germans reveals the limited influence Britain had on events at this time. Threats to float sterling were received with concern but were not enough to induce favourable changes in policy on foreign governments dealing with their own domestic concerns.

Meeting with representatives of the Treasury and Bank of England on 18 November, Jenkins discussed the news from the meeting of central bankers in Basle the previous weekend. The French had indicated they were preparing to devalue, almost a year exactly since the sterling devaluation of 1967. Some in the Treasury argued that British un-competitiveness had been underestimated the previous November and that a second devaluation should be considered but Jenkins decided to lean

¹³⁵ Heide-Irene Schmidt “Anglo-American Relations and International Monetary Policy, 1958-69” p199

¹³⁶ O’Hara “The Limits of US Power” p 268

on the Americans, demonstrating his commitment to the stability of Breton Woods. It was therefore agreed that Jenkins would inform the Americans that a German revaluation, ideally of 20% but of an absolute minimum of 5%, would be necessary to prevent sterling floating in the event of a French devaluation.¹³⁷ The next day Jenkins called Fowler to stress the importance of closing foreign exchange markets to buy time for sterling while a solution to the franc/deutschmark crisis was found. Fowler agreed that there should be no difficulty in closing the New York market, though doubted the Swiss could be persuaded to close theirs.¹³⁸

On the afternoon of 18 November, O'Brien reported from Basle that although the French did not consider themselves to be in fundamental disequilibrium, there had been a flight of capital from their reserves which they were not willing to offset through borrowing. The French were pressing for a German revaluation of 15% but were willing to share an aggregate adjustment with them through a partial devaluation. O'Brien had unveiled the threat of floating sterling and noted it had been received with "deep concern."¹³⁹ However this was not enough to force the required adjustment. Prior to a meeting of the Group of Ten finance ministers on 20 November the Germans pre-empted the meeting by releasing a statement on the 19th decisively ruling out any revaluation of the deutschmark, proposing instead a border tax adjustment which they claimed would be equivalent to a revaluation of 4%.¹⁴⁰

At this point the British and American approach to resolving the crisis diverged. The British believed the best course of action would be to force the Germans to change direction; in a telegram to the President, Wilson described the French issue as of "secondary problem" which could be contained with relative ease.¹⁴¹ Wilson then summoned the German ambassador just after midnight to denounce the German measures as "barely a third of what was required" and threatened to

¹³⁷ TNA T312/2064 "Note of a Meeting" 10.30 AM 18 November 1968

¹³⁸ TNA T312/2064 "Note for the Record" 19 November 1968

¹³⁹ TNA T312/2064 "Note of a Meeting" 4.15pm 18 November 1968

¹⁴⁰ TNA T312/2064 "German Government Statement" 19 November 1968

¹⁴¹ TNA T312/2064 "Message from the PM to the President" 19 November 1968

withdraw the British military presence in Germany.¹⁴² In contrast, Johnson preferred to focus on preventing the French from devaluing, believing the “native German dislike of throwing a strong financial position,” meant pushing for a German revaluation was a lost cause.¹⁴³

The actual conference on 20 November appeared to vindicate the President’s approach, but not before the debacle of adjustment under Bretton Woods was laid clear beneath the gaze of the world’s press. The Germans were defiant in defence of their policy, indicating they were prepared to increase swap credits by \$600m provided to other countries and extend them for 6 months. “What [are] other countries prepared to do?” Karl Schiller, the German minister for Economic Affairs rhetorically demanded.¹⁴⁴ Conversely, after negotiating a devaluation of the franc, de Gaulle then vetoed it as “the worst absurdity,” thus inadvertently preserving the competitiveness of sterling, if only for reasons of French prestige.¹⁴⁵ According to *The Times*:

If a script had been written with the purpose of making people believe that the world currency system was breaking down, it could not have been more strikingly devised.¹⁴⁶

Due to the French decision not to devalue, the British threat of a second devaluation was not called out. Nevertheless, the British did resort to tighter credit controls and an import deposit scheme under which importers paid 50% of the value of their goods before they were brought into the country.¹⁴⁷ As such, Britain ended the year with the outlook for her balance of payments marginally improved.¹⁴⁸ Nevertheless, the failure of the Bonn conference to establish new parities for the franc and the deutschmark meant new exchange crises would be forthcoming in 1969. What had been demonstrated was the true cost of Britain’s commitment to Bretton Woods. While 1968 had

¹⁴² TNA T312/2064 "Record of a Conversation" 12.30 AM 20 November 1968

¹⁴³ TNA T312/2064 "Telegram from Dean to Foreign Office" 19 November 1968

¹⁴⁴ TNA T312/2064 "Telegram from for Figures" 21 November 1968

¹⁴⁵ Quoted in John Williamson, *The Failure of World Monetary Reform 1971 -74* (Sunbury: Thomas Nelson, 1977) p7

¹⁴⁶ *The Times* 23 November 1968

¹⁴⁷ O’ Hara “The Limits of US Power” p 268

¹⁴⁸ Newton “Sterling, Bretton Woods and Social Democracy” p446

involved substantial support for sterling, it had also required significant public expenditure cuts and expensive inducements to maintain holdings in sterling, with little progress on monetary reform that would resolve the overhang. The politicised nature of adjustment in Bretton Woods meant the achievement of an external surplus was a protracted affair, dependent on the decisions of other countries. In contrast to Wilson's claims a year previously that devaluation marked the end of "rigid limitations on the ability of our people and government to solve our problems by our own exertions," by the end of the year these limitations appeared more rigid than ever.

4.8: Stabilising Sterling – January 1969 – October 1969

Sterling remained unstable throughout the first half of 1969. The threat of a fresh exchange crisis involving the franc and/or Deutschmark underlined British apprehension about the stability of their own currency.¹⁴⁹ Given the slow progress of international reform, the threat of floating the currency and blocking the balances made at the Bonn conference was not an empty one. Despite the commitment to Bretton Woods made by the Labour government, the danger of crashing out was never from the leadership's minds during the repeated crises following devaluation.

The commitment made to defend the new parity of 1967 could not of course be absolute, any more than the one made in 1964 had been. Indeed, despite reiterating to the Americans their desire to maintain their commitment to the parity, within the British Treasury there was a genuine fear that with the balance of payments still stuck in deficit at the beginning of the year, a French devaluation without a corresponding German appreciation would seriously imperil what prospects for surplus then existed. The grave nature of the British position was laid out in a series of contingency plans that were developed in the Treasury. Together, they demonstrate how limited Britain's room for manoeuvre was within the framework of their commitment to defend and reform Bretton Woods.

¹⁴⁹ *Ibid* p446

While this commitment eased the financing constraint with liquidity available via the IMF and BIS, it also made Britain the captive of events, ceding initiative to Washington, Paris and Bonn.

Hecuba, the codename for a unilateral float between the start of the year and the spring budget, detailed the proposed response to a result of a crisis of confidence in sterling resulting from either some external source or domestic instability. The first question Hecuba asked policymakers was whether Britain should add “to our already enormous short-term debts by further borrowing?” If not, then floating would be the only option. As the paper acknowledged, this would be “a grave decision,” and listed the likely effects as devaluation by other countries, leaving America in an exposed and uncompetitive position and therefore provoking the suspension of gold sales by the US, undermining the cornerstone of Bretton Woods.¹⁵⁰

The causality could also run in the other direction as changes in Bretton Woods impacted on sterling. Proetus dealt with likely ramifications of a US embargo on the sale of gold, brought about by a run on gold or a series of devaluations, specifying an excessive devaluation of the franc. Would the Germans allow the Deutschmark to appreciate to restore stability to the system? It was “impossible to say” according to the Treasury planners, although if the Germans refused to it would leave the dollar “in a curious and exposed position, overvalued and unable to do anything about it.” This would not necessarily be a concern for the US, since the discipline provided by gold convertibility would have been removed, allowing the US to flood the world with unconvertible dollars and putting the onus on Europeans either to absorb them or revalue their currencies.¹⁵¹ This ‘benign neglect’ would indeed be the American policy after suspending convertibility in August 1971. However, by then the prospects for sterling had improved, (albeit temporarily), and Britain was in the novel position of managing a capital inflow.

¹⁵⁰ TNA T295/607 "Group on Contingency Planning Hecuba" 14 January 1969

¹⁵¹ TNA T295/607 "HM Group on Contingency Planning Proetus II" 15 January 1969

According to Oliver and Hamilton in their extensive review of these contingency plans, Britain understood the need for greater flexibility in the world's monetary system but planning for it in 1968/69 was undertaken "from a position of weakness and as a unilateral response."¹⁵² From the perspective of the constraints imposed by Bretton Woods, they reveal the costs of leaving the system. On balance, British policy makers decided that the British interest remained in defending Bretton Woods and remaining subject to its provisions on liquidity, confidence and adjustment. However, by 1969 this was no sure thing. Avoiding floating would require fresh borrowing, something the government might not be prepared to accept, due to either the large stock of existing borrowing or because of unacceptable conditions attached to the loan. As a paper on the subject noted, Britain's short and medium-term debts now totalled over £3.4 billion, not far short of the liabilities incurred during the Second World War. A further crisis and defence of the existing sterling rate could see the debts break the £4bn mark. At this stage it was the total stock of debt that was the most pressing concern. Conditions on borrowing from the IMF had not so far been an issue. Borrowing short term from other central banks could conceivably raise conditions, but as Ryrie of the Treasury argued, they were unlikely to demand policies that the British were not already following.¹⁵³

Although 1969 was the year of the long awaited turnaround in Britain's balance of payments there was one last crisis to be navigated, a sequel to the Bonn conference involving an eventual correction of the Deutschmark and franc parities. As before Britain looked to align its policy with the Americans but since the beginning of the year faced a new administration following the decision of Johnson not to stand for re-election and the subsequent victory of Richard Nixon over Hubert Humphrey. The initial contact with the new administration took place in January when Paul Volcker, the US Treasury official responsible for international monetary affairs, visited London. Jenkins took the opportunity to argue that the appearance of new speculative pressures at any time could make new credit to

¹⁵² Oliver and Hamilton "Downhill from Devaluation" p499

¹⁵³ TNA T295/607 "Hecuba: The Question of Further Borrowing" 27 January 1969

support sterling necessary, while reaffirming his government's commitment to the parity even in the event of a franc devaluation within a "justifiable" range. Volcker made politely non-committal noises, advising Nixon to stick to the line that further credit would be very difficult to arrange, without "shutting the door" to any future arrangements.¹⁵⁴

May 1969 witnessed renewed speculation against the franc and the Deutschmark, negatively impacting sterling as traders moved into the Deutschmark in anticipation of a revaluation. The speculation hit sterling particularly bad, with the reserves losing over \$200m in one day, while Jenkins described 16 May as "the nadir of my whole Treasury experience" as money flowed out of the reserves to defend the rate.¹⁵⁵

This development was noted with concern in Washington. According to a briefing paper for the President on 2 May, while both a franc devaluation and Deutschmark revaluation were probably inevitable, there was a danger that they would not come soon enough to prevent a massive run on the pound, leading to devaluation, floating, and/or protectionism.¹⁵⁶ The US was therefore inclined to look favourably on a request for another IMF standby by the British. Maude of the British Treasury had first sounded out Schweitzer on the possibility of further support at the end of January 1969, to which the head of the IMF had agreed the British had "virtually no alternative."¹⁵⁷

While liquidity was once again available to help manage the external constraint imposed by Britain's continued commitment to Bretton Woods, the repeated calls on the IMF's resources to support sterling provoked fresh demands for Fund oversight on economic policy. In response to the request for fresh support in 1969, the IMF was clear this would require a second Letter of Intent. This would include some commitment to a ceiling on Domestic Credit Expansion [DCE], which was a wider

¹⁵⁴ Foreign Relations of the United States 1969 - 1973 Vol. 3 Foreign Economic Policy; International Monetary Policy 1969-1972 "Telegram From the Embassy in France to the Department of State" 09 Feb 1969

¹⁵⁵ Jenkins *A Life at the Centre* p275

¹⁵⁶ FRUS 1969 - 73 Vol. 3 Action Memorandum From the President's Assistant for National Security Affairs (Kissinger) to President Nixon" 02 May 1969

¹⁵⁷ TNA T326/978 "Another IMF Standby" 31 January 1969

definition of money supply than had been included in 1967, being equal to money growth added to the net deficit on balance of payments.¹⁵⁸

DCE proved a sticking point in negotiations with the IMF as it was counter to the official British understanding of monetary policy and therefore potentially represented an intrusion on formulation of policy. According to the theory, when DCE ran ahead of forecast it represented an economy that overheating, a deteriorating balance of payments or a combination of the two. There were 4 options open to a government to restrict DCE and bring the economy and balance of payments back into equilibrium. 1: Exchange control restrictions, 2: Actions to reduce Public Sector Borrowing Requirement, 3: Restraint on credit to the private sector 4: increased sales on government debt outside the banking sector.

Dealing with each in turn, the UK Treasury was reluctant to credit them with much application to the problem in hand. 1: would be presumably unacceptable to the IMF, while it was not thought there was much scope for option 2 given the cuts of the previous year. Option 3 was considered to be already in place, while 4 was thought not applicable to the UK given the volume of outstanding debt and the importance of confidence.¹⁵⁹ There were also more philosophical disputes regarding DCE. The Fund wanted DCE to be used as an indicator for trouble and to prompt the need for corrective action. According to this strand of thinking, the causality ran from excessive demand to the money supply. This was in line with the general intellectual atmosphere at the time in mainstream UK policy circles. However, the more contentious strand in IMF thinking was the argument that there was a feedback from increases in DCE into increases in real demand. This was the strand of monetarism that had begun to influence policy, first in the IMF and then outwards into other policy centres. In the Treasury's view, the IMF (and monetarists in general) discounted effects in changes in liquidity preference and variations in velocity, although the Treasury noted that the IMF did not associate

¹⁵⁸ TNA T326/978 "IMF Standby and Overall Credit Ceiling" 07 February 1969

¹⁵⁹ TNA T326/978 "IMF Standby and Overall Credit Ceiling" 07 February 1969

itself with the extreme “Friedmanite” view that credit restraint was an “intrinsically superior” form of economic management, only that it should not be neglected.¹⁶⁰

At this stage however, the IMF was not dogmatic in its advocacy of the new tool and Schweitzer seemed amenable to some negotiation on what the British commitment would be when Rawlinson of the Treasury raised some of the British difficulties with the concept.¹⁶¹ The IMF mission arrived in London in April. According to Rawlinson, the importance of the standby was critical. As in 1976, the Fund’s ‘seal of approval’ endorsing the current policy mix could be as important in placating market perceptions as the money itself:

We need the money...also if we fail to conclude an agreement with the IMF, our creditors, who to some extent rely on the lead from the Fund, may draw the conclusion that our policies are in some way defective.¹⁶²

Once again Richard Goode led the Fund’s delegation to London. In discussion on the projected British balance of payments, Goode took the view that it was both disappointing and optimistic. Goode believed that a higher target for surplus should be set for £300m for the financial year, but that it was dangerous to rely on local authorities and public corporations borrowing to bring in £100m on the capital account. So soon after fiscal adjustment, it was therefore essential to establish credit restraint to improve the balance of payments and restore reserves.¹⁶³ In response, the Treasury stated that it would be very difficult to justify further measures, in both the fiscal and monetary fields, so soon after the Budget without a serious effect on confidence.¹⁶⁴

In a meeting between Goode and Jenkins and his Treasury team at the beginning of May, Jenkins explained his reservations were not due to any philosophical objections to a tight monetary policy. He conceded monetary policy was the weapon to use given that further fiscal tightening or cuts in

¹⁶⁰ TNA T326/978 “IMF Standby and Overall Credit Ceiling Outline of Submission to Chancellor on Main Issues” 13 February 1969

¹⁶¹ TNA T326/978 “Note for the record” 13 February 1969

¹⁶² TNA T326/978 “IMF Standby” 16 April 1969

¹⁶³ TNA T326/977 “Domestic Credit Expansion Negotiations with the IMF mission” 30 April 1969

¹⁶⁴ TNA T326/977 “Brief for a meeting with IMF Mission” 30 April 1969

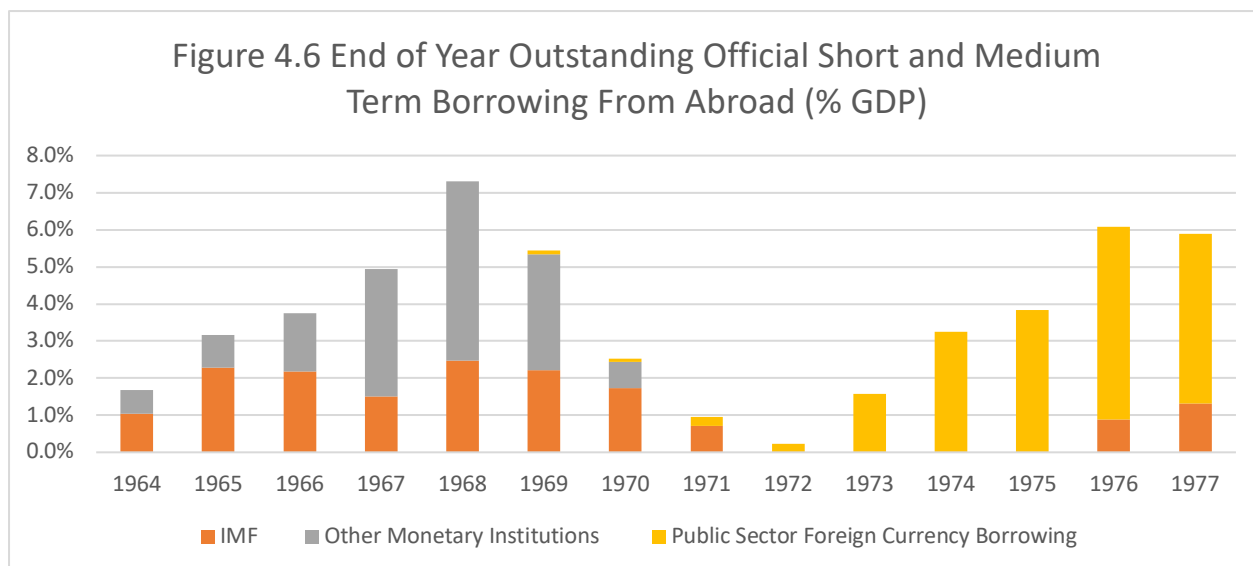
public expenditure were not currently practical. The problem Jenkins and his team had was that it was not, in their opinion, as precise a tool as the IMF believed, and in any case, it was politically important for the government not to appear to be taking instruction from the IMF.¹⁶⁵ This was to stand in stark contrast to 1976 when it was only through the appearance of Britain taking political instruction from the Fund that market confidence returned to sterling.

Once again Britain was able to secure access to financial support for sterling without conceding any meaningful commitments to the Fund regarding policy. The IMF agreed to \$1bn support in four drawings, starting at the end of June. Although Britain was set quarterly targets for credit growth, these were construed as commitments by the British representatives at the IMF rather than from the Chancellor himself. Jenkins and his Treasury team stood firm in their refusal to countenance any binding targets for British credit growth, instead threatening to walk away and warning about the danger that failing to agree a deal would pose to the world's monetary system.¹⁶⁶

The relative ease with which Britain secured the IMF's support in 1968/69 stands in stark contrast to 1976, when contentious debates erupted over the size of the PSBR and rate of money growth. Under Bretton Woods, the shared Anglo-American commitment to the system's defence and reform meant support was available to sterling without detailed conditionality. Nevertheless, the political commitment to the system's rigid adjustment and limited liquidity constrained Britain in other ways. As we have seen, measures to restore confidence stabilised the sterling balances but did not reduce them. Meanwhile defence of the post-devaluation exchange rate required a higher stock of debt being assumed to stabilise the currency than later, even including the public sector's use of foreign capital markets in the lead up to the 1976 crisis (see Figure 4.6).

¹⁶⁵ TNA T326/979 "Note for the Record" 05 May 1969

¹⁶⁶ Schenk *Decline of Sterling* p202



Source: Bank of England Quarterly Bulletin, 1976 Q1 "UK Official Short and Medium Term Borrowing From Abroad"; Bank of England Quarterly Bulletin, 1978 Q1 Table 24 "UK Official Short and Medium Term Borrowing From Abroad"

The IMF money and, more importantly, improvement in Britain's external account allowed Britain to ride out a final wave of currency speculation as the franc and deutschmark were adjusted over the second half of 1969. Following the resignation of de Gaulle in April, the resistance towards adjustment for reasons of prestige within France had evaporated, and a unilateral 12.5% devaluation was announced on 8 August.¹⁶⁷ This resulted in renewed speculation that a deutschmark revaluation was on the cards. What followed next was a significant break with the accepted norms of Bretton Woods adjustment as the Germans let the DM temporarily float in September in response to massive capital inflows before setting a renewed parity in October.¹⁶⁸

While the successful experiment of floating the DM reinforced academic calls for introducing greater flexibility into international adjustment, in the immediate term the realignment of both the DM and franc stabilised Bretton Woods. Britain's efforts finally began to pay dividends for the British as the

¹⁶⁷ Newton "Sterling, Bretton Woods and Social Democracy" p446

¹⁶⁸ William Glenn Gray "Floating the System: Germany, The United States, and the Breakdown of Bretton Woods, 1969 – 1973" *Diplomatic History* (2007) Vol. 31 (2) p. 304; Susan Strange, *International Economic Relations of the Western World Vol. 2 International Monetary Relations* (London: Royal Institute of International Affairs, 1976) p330

current account moved into a sustained surplus. As we have seen this had not been without cost. Britain resisted floating sterling, incurred debt to defend the parity while also agreeing to the expensive Second Group Arrangement to restore confidence among the sterling balance holders. However, the availability of sufficient support had meant this cost was bearable while Britain's integration into the world's open trading order had been maintained. These commitments had been entered into on the understanding that the best resolution for sterling balance problem lay in a general reform to the system's provision of liquidity. This in turn depended on American attitudes towards reform, a position that was undergoing transition as a result of the newly elected Nixon administration.

4.9: Richard Nixon & Anglo-American Reform Discussions *January 1969 – October 1969*

The entry of Richard Nixon into the White House at the beginning of 1969 marked the beginning of a transition in American attitudes towards Bretton Woods that culminated in the Nixon Shock of August 1971. This was to have profound implications for the monetary system, loosening the multilateral commitment to stability and reform upon which British hopes for a solution to the sterling overhang depended as well as undermining the key source of influence sterling's weakness gave the British in securing financial support.

In the immediate term however Nixon's actions contributed to the stabilisation of Bretton Woods, following on from the realignment of the DM and franc, that helped facilitate British transition to surplus over the year. Nixon's immediate concern was the state of the domestic US economy. The previous administration had primed the economy through its spending on Vietnam and Johnson's Great Society programmes of increased domestic welfare spending.¹⁶⁹ In response Nixon's new administration endorsed the ideas of the Chicago economist Milton Friedman and initiated a policy of 'gradualism' in monetary policy, predicated on a stable and predictable growth of the money

¹⁶⁹ James Patterson, *Grand Expectations The United States 1945 – 1974* (Oxford: Oxford History of the United States, 1998) p531

supply.¹⁷⁰ Accordingly, Martin raised the discount rate to 6%, the highest in 40 years. Since banks were restricted on the interest rates they could offer (through Regulation Q, part of the 1933 Banking Act), once Treasury rates rose above the ceiling, they faced a liquidity crisis as savers switched to Treasury bills. Inadvertently, this stabilised Bretton Woods as banks borrowed on the Eurodollar market, pushing up rates there and keeping the dollar strong as capital flowed towards the US.¹⁷¹

Less beneficial to Bretton Woods was Nixon's Secretary of the Treasury David Kennedy's first press conference in which he made some "curiously ambiguous remarks" about gold, repeatedly declining to affirm the government's commitment to \$35 per ounce, despite being warned by reporters that it would invite speculation. Kennedy instead insisted that he wished to leave "every option open," setting off a brief run on the dollar.¹⁷² This ambiguity towards the founding principles of Bretton Woods would ultimately result in the US unilateralism of the Nixon Shock in which the Americans broke the gold dollar link in August 1971 without consultation of its allies, notably Britain.

The British were not blind to the prospect that the pressures of defence of Bretton Woods might induce Washington to think in terms of radical alternatives. As the British economist John Williamson noted, the US could not deflate sufficiently to reduce its deficit, since the American propensity to import was so small. Accordingly, they looked to other countries to act, such as revaluation on the part of the deutschmark. This also tied into their wider geopolitical objectives. As Williamson noted:

The US wishes to play a global role in which foreign exchange shortages do not act as a constraint on foreign policy. This implies the desire for a system in which either 1) their deficits are automatically financed or 2) adjustment occurs promptly and smoothly. They are rich enough to be indifferent to which of these occurs and also to the income redistribution that results from different arrangements about reserve assets.¹⁷³

¹⁷⁰ Allen J. Matusow *Nixon's Economy: Booms, Busts, Dollars and Votes* (Lawrence: University Press of Kansas, 1998) pp. 17 - 20

¹⁷¹ Chalmers *International Interest Rate War* (London: Macmillan, 1972) pp.104 - 105

¹⁷² *The Times* 19 December 1968

¹⁷³ TNA T312/2334 "Talks with the Americans" 27 March 1969

Williamson believed that this meant that while the US would threaten suspending convertibility, it would not in the end actually resort to it, out of the fear unilateralism in monetary policy would undermine other foreign policy objectives.¹⁷⁴ The Bank of England was less sanguine, noting presciently that the Nixon administration was looking for a sphere in which a bold initiative was possible, under pressure from Congress to lessen the impact of Bretton Woods on the domestic economy and inclined to be more demanding of increased foreign contribution to the upkeep of the Western economic and security order.¹⁷⁵

In their direct contact with the British, the Americans at this point remained committed to Bretton Woods. At the beginning of March, Volker and Solomon headed the US delegation that met Maude, Rawlinson and Figgures from the British Treasury. After a discussion on international interest rates, the talk turned to the SDR proposals. Here, the primary issue was when they would be activated, and in what quantity. While acknowledging the trade-off between speed and certainty – the risk that moving too quickly would antagonise those who had doubts about the scheme – Volcker informed the British that the US was in favour of an early activation and wanted to move the debate away from the \$1bn - \$2bn range currently proposed towards a more significant offering. This, Volcker argued, would have a calming effect on the world's monetary system, both by relieving liquidity strains which were increasingly apparent in light of the American domestic credit squeeze, and by demonstrating that the world authorities were capable of concerted action towards reforming the system.

The British delegation agreed in favour of early activation of SDRs, although Figgures acknowledged the extent of SDRs could be a source of embarrassment for the British, since a campaign for a large amount might be taken as searching for a means to finance the deficit without adjustment. On the

¹⁷⁴ *Ibid.*

¹⁷⁵ TNA T312/2334 "USA" 02 April 1969

contrary, Figgures claimed, the British wanted SDRs to assist in running a surplus; since under the current system, a deficit implied deterioration in another country's balance of payments.¹⁷⁶

Although these talks delivered nothing concrete, they demonstrated the compatibility of thinking on both sides of the Atlantic regarding the SDR, forming a basis for a common front aimed at activation. In July, Group of Ten deputies hammered out agreement on the timing and scope of SDR activation. Under the agreement, \$9.5bn of SDRs were to be introduced over the three years, with \$3.5bn in the first year, beginning 1 January 1970.¹⁷⁷ The required amendments to the Fund's articles occurred at the Fund's General Meeting in September 1969.¹⁷⁸ Although in hindsight we can see that the system was about to be flooded with liquidity as Nixon unleashed a domestic boom with an eye on re-election, the tight monetary conditions prevailing in 1969 (see above), appeared to vindicate those who argued that the system required a controlled increase in liquidity as American transitioned back to surplus.¹⁷⁹ The path to gaining European acquiescence to the SDR scheme had involved assurances that they would not be used to fund the sterling balances. Nevertheless, there remained hope in London that the system might evolve in that direction.¹⁸⁰ The ratification of the SDR, and the general movement of opinion towards greater flexibility in adjustment appeared to offer potential to ultimately resolve the constraint imposed by the sterling overhang, justifying the cost of commitments made since devaluation.

4.10: Conclusion

While in hindsight devaluation can be seen as the beginning of the end for Bretton Woods, at the time both American and British policy was based on the objective of defending and reforming it. For the British this involved a renewed commitment to the system, involving defending the post-devaluation exchange rate peg throughout the repeated crises that followed. This commitment was

¹⁷⁶ TNA T312/2334 "Note of a meeting at the US treasury 3.30pm" 03 March 1969

¹⁷⁷ FRUS 69 - 76 Vol 3 "Telegram From the Embassy in France to the Department of State" 25 July 1969

¹⁷⁸ *The Times* 01 October 1969

¹⁷⁹ James *International Monetary Cooperation* p171

¹⁸⁰ Schenk *Decline of Sterling* p269

based on a number of justifications. There was a profound psychological fear that collapse in Bretton Woods could herald a return to the instability of the inter-war period. More positively, Labour's export led growth strategy relied on a stable framework of trade and investment to provide demand for British goods. The prospect that reform to the system's provision of liquidity raised hopes that a multilateral solution to the problem of sterling's reserve role might be forthcoming.

The argument advanced here is that this political commitment to Bretton Woods determined the nature of the constraint faced by Britain during this time, as well as Labour's ability to negotiate it. Following the one-off improvement to competitiveness following devaluation, adjustment remained rigid, with floating or a second devaluation considered only as a last resort. Liquidity to fund deficits and diversification was limited and mediated through international institutions. The commitment to Bretton Woods took priority, requiring a proportionally greater adjustment than would occur in 1976, as well as higher borrowing to stabilise sterling, despite other fundamentals such as control of inflation and the money supply being in better shape. This indicates the constraint that the increasingly inflexible Bretton Woods system imposed on sterling.¹⁸¹

Labour's economic diplomacy proved successful in securing repeated rounds of IMF and central bank support with which to defend the rate, leveraging the importance of sterling to the system.

Attempts to impose conditionality on policy were easily evaded, although given the extent of Labour's commitment to Bretton Woods revealed in their domestic retrenchment, these were unnecessary in any case. More significantly, external support packages to improve confidence in sterling, notably the 1968 Basle deal, were predicated on the continuation of Bretton Woods, involving expensive inducements in the form of exchange rate guarantees and high interest rates which facilitated a fresh accumulation in the sterling balances rather than their reduction. This would eventually need to be resolved during the 1976 IMF crisis.

¹⁸¹ J. E. Wadworth [ed.] *The Banks and the Monetary System in the UK 1959 – 1971* (Abingdon: Routledge, 2006) p458

From the perspective of 1970 however, the Labour could congratulate themselves on transitioning to surplus within a stabilised Bretton Woods that had progressed on important reform in the shape of SDR activation. Crucially throughout this period that could rely on American financial support and institutional influence. This was based on the Americans' own political commitment to Bretton Woods under President Johnson, and the attempt of Richard Nixon to cool down the domestic US economy during his first year in power, which had the simultaneous effect of stabilising the wider international monetary system. As the subsequent years would demonstrate, the American commitment to Bretton Woods would also have important consequences for resolving the sterling overhang.

Chapter 5

Going it Alone

5.1: Introduction

One of the most fundamental breaks in international monetary relations occurred on 15th August 1971. Nearly four years since sterling's devaluation had begun an existential crisis of the Bretton Woods system, President Nixon appeared on television to announce a series of measures that proved fatal. Alongside a 90-day freeze on wage and prices and a 10% surcharge on imports, Nixon unilaterally suspended the convertibility of dollars into gold. In doing so, he ushered in an international monetary system based on fiat, floating currencies that endures to the present day.¹

The Nixon Shock also dealt a severe blow to Britain's sterling strategy. The joint Anglo-American commitment to defending and reforming Bretton Woods based on their shared identities as issuers of international currencies had formed the basis of British attempts to resolve the sterling balances. In a stroke, Nixon had undermined this approach, acting without prior consultation of the British and demonstrating that the shared status of the dollar and sterling was a mirage. Rather than reform the system's provision of liquidity, Nixon leveraged the dollar's status as top currency to enforce adjustment on other economies. This new approach was personified by Nixon's combative Secretary of the Treasury John Connally who famously declared "foreigners are out to screw us. Our job is to screw them first."²

The breakdown of Bretton Woods resulted in a reconfiguration of the external constraint. The inauguration of floating exchange rates for the first time since the war meant domestic expansion

¹ John S. Odell, *US International Monetary Policy: Markets, Power and Ideas as Sources of Change* (Princeton: Princeton University Press, 1982) p267

² Gavin, *Gold Dollars & Power* p194

could proceed without concern for defending the parity. With confidence in sterling secure thanks to the hard won surpluses and guarantees of the 1968 Basle Deal, Edward Heath's Conservative government could avoid the apparent mistakes of the previous Labour government and prioritise domestic expansion. However, the sterling overhang remained, while progress on reform to the system's provision of liquidity was washed away in the flood of unconvertible dollars unleashed by the Nixon Shock. The British response to the Nixon Shock was complicated by Britain's third and final application to the EEC. Despite a nominal commitment to reduce sterling's reserve role as part of Britain's accession however, no policies were put into place to bring this about. The exchange guarantees of the 1968 Basle deal were extended to stabilise the level of the balances in response to the expected return of a current account deficit resulting from Heath's reflationary policies. Heath attempted to secure European backing for sterling as part of an acceleration of plans for monetary union, however his reconfiguration of the external constraint prioritised domestic expansion over fresh commitments for sterling. His demands for joining the re-pegged European exchange rate system (the so-called Snake in the Tunnel) – unconditional and unlimited support – precluded Britain's participation. This facilitated his domestic expansion but at the cost of a widening current account deficit just as the OPEC oil shock occurred at the end of 1973.

Edward Heath's time in power has not been remembered favourably by historians. He came to power promising deliverance from the problems afflicting the British economy in the 1960s – excessive government intervention, deteriorating industrial relations, 'stop-go' economic growth and rising inflation – only to leave in 1974 with these fundamentals in a worse state than ever.³ His most significant decision in monetary relations was to float sterling in 1972. Oliver and Hamilton argue that the success of the 1968 Basle Arrangements in "making the hitherto volatile sterling

³ Stewart *Politics and Economic Policy in the UK* p138; More sympathetic accounts allude to Heath being "conspicuously out of luck," as Alec Cairncross has noted, dealing with crises related to the collapse of Bretton Woods, the OPEC oil shock and a return to high inflation that the prevailing Keynesian paradigm was ill equipped to deal with, see Martin Holmes *The Failure of the Heath Government* (Basingstoke: Macmillan, 1997) p. xiii

balances inert” meant that floating could now be considered seriously as a matter of policy that would not necessarily require moves as destructive as blocking sterling convertibility.⁴ For Newton, the decision to float the currency implied that the Conservatives were not prepared to follow the example of the Wilson government and sacrifice growth in return for balance in external payments and stability in the exchange rate, noting “the commitment to expansion seemed absolute.”⁵

Catherine Schenk argues that the official end of the Sterling Area in 1972 marked a “mere footnote” in the realignment of British economic policy towards the EEC.⁶ Nevertheless, the balances remained a threat to sterling’s stability and the extension of the Sterling Agreements and the exchange rate guarantee (now applied to a floating rate), meant an ongoing contractual relationship between Britain and balance holders aimed at managing diversification.⁷ However under Heath this relationship was initially viewed through the prism of Britain’s role in Europe. Sterling’s position as an international currency proved a stumbling block in EEC membership negotiations but the Europeans were placated by a British commitment to run down the sterling balances and did not insist on action prior to accession. According to Schenk, the subsequent recognition that resolution of sterling balance problem was beyond the scope of Europe shifted the management of sterling’s decline back towards a global context, requiring both American support and the cooperation of the sterling holders themselves.⁸ Although analysing in detail the role of sterling in Britain’s third application to join the EEC, Schenk downplays Heath’s subsequent attempts to secure a European solution for the sterling balances, noting only that Heath’s attempts to do so as a quid pro quo for joining the new European arrangements on exchange rates were subsequently dashed.⁹

From the perspective of the thesis, the Heath government forms a bridge between the renewed build-up of sterling balances following devaluation with their eventual resolution in 1976/77.

⁴ Oliver and Hamilton “Downhill from Devaluation” pp.509-510

⁵ Newton *The Reinvention of Britain* p80

⁶ Schenk “The Sterling Area and Economic Disintegration.” pp. 27-28

⁷ Schenk “The Shift from Sterling to the Dollar, 1965–76: Evidence from Australia and New Zealand” pp.13-14

⁸ Schenk *The Decline of Sterling* p154

⁹ *Ibid* p346

Explanations of the IMF crisis usually look to the deficits that resulted from Heath's over-expansionary policies (unfairly coined the 'Barber Boom' after his Chancellor) which were then exacerbated by the impact of the 1973 OPEC oil shock. The thesis however shows that it was Heath's response to the changes in in the international monetary system rather than domestic policy *per se* that left Britain exposed by the end of 1973. This involved an attempt to renegotiate Britain's external constraint imposed by monetary commitments through securing greater flexibility in external adjustment combined with European support for the sterling balances. These proved incompatible as Heath prioritised domestic expansion.

Heath was determined not to repeat the experience of Wilson in sacrificing domestic growth to defence of the exchange rate. Floating sterling in 1972 was a political choice to prioritise domestic growth in response to capital outflow, rather than an economic necessity as Britain possessed more than enough reserves to defend the rate. The breakdown in the Bretton Woods commitment to pegged exchange rates following the Nixon Shock meant however that it now seemed unnecessary to spend reserves or accumulate debt when the exchange rate itself could take the strain.¹⁰

Despite this breakdown in systemic provisions of exchange rate adjustment however, the normative commitment to cooperation in international monetary relations and open, multilateral trading relationships remained.¹¹ Heath was aware that the re-emergence of a current account deficit as his domestic measures picked up speed meant the issue of the sterling overhang would soon be raised again. The breakdown in monetary reform following Nixon's benign neglect of the dollar and Heath's own inclinations meant he looked towards Europe. The European response to the monetary turmoil afflicting the global economy following the Nixon Shock was an attempt to recreate the stability of Bretton Woods along European lines. Against the trend towards greater flexibility, the Europeans

¹⁰ Leland B. Yeager *International Monetary Relations: Theory, History and Policy* (New York: Joanna Colter Books, 1976) p467

¹¹ Ruggie "International Regimes, Transactions and Change" p384

looked to establish a pattern of intra-EEC exchange rate pegs based on narrow bands of fluctuation – the so-called Snake in the Tunnel.¹²

Heath's initial response was enthusiastic, believing that this would require common pooling of reserve assets and liabilities and so resolve the sterling overhang. He was reassured by German offers of unconditional and unlimited support with which to manage a sterling peg but was subsequently disappointed when this did not materialise. Although his European partners wished to see sterling's international role scaled down (extracting an explicit commitment to this end as part of the British application), they had no desire to assume Britain's liabilities as a means of doing so. From the perspective of Paris and Bonn, support for sterling would be forthcoming only once Britain adhered to the nascent mechanisms for monetary union, including re-joining the Snake. This was intolerable to Heath, who believed the lesson of Wilson's government was not to let international obligations over sterling's stability stand in the way of domestic expansion and accordingly would not commit to re-pegging sterling unless support was first made available, unconditionally and without limit. Unsurprisingly, little progress was made.

Heath's political commitments therefore secured flexibility in adjustment, allowing domestic expansion to proceed without immediate concern for the exchange rate or current account deficit. However, in doing so he also isolated sterling from potential European support while making no progress on resolving the issue of the sterling overhang. This prioritisation of domestic growth over fresh international commitments meant in contrast to Wilson's claims at devaluation, Heath really did try and go it alone.

Although the attempt to fix European exchange rates in any rate did not long survive the accelerating inflation unleashed by the OPEC oil shock at the end of 1973, the discipline imposed by the exchange rate commitments did limit participants' exposure to the fresh economic crises that erupted from 1974 onwards. Italy, the other country to drop out of the Snake at an early juncture,

¹² Eichengreen *Globalizing Capital* pp 149- 152

significantly also required IMF support following the oil shock.¹³ Ultimately Heath's attempts to renegotiate the external constraint did not improve Britain's position, undermining sources of support while at the same time increasing the demand for such support

5.2: Edward Heath and the Conservatives in Power

Heath arrived in power in an election characterised by concerns about the economy. Despite the comfortable surplus that had been built up by the time of 1970 budget, Jenkins had resisted calls within the cabinet for a "sloshing working class budget," in favour of continuing the post-devaluation trajectory in government spending.¹⁴ Labour's lead in the polls was eroded over the campaign as concerns over rising inflation, disappointment with the budget and trade union resentment over Labour's handling of industrial relations legislation combined with a shock external deficit for June (caused by the government purchase of two Boeing Jets). The result was a narrow victory for the Conservatives, with Heath becoming Prime Minister in June.¹⁵

During the campaign, Labour had characterised Heath's Conservatives as free market radicals.

Wilson coined the term 'Selsdon Man' as shorthand for the Conservatives' proposed policy reforms that included tax cuts, reduced government intervention and trade union reform.¹⁶ This however backfired on Labour by making Heath appear more dynamic and radical than he was. Like Wilson's 'White Heat' promises in 1964, 'Selsdon Man' offered something new and appealed to the individualism of the aspirational suburban working and lower middle class.¹⁷ However, as his response to the challenges of the early 1970s demonstrated, Heath was very much a continuation of the post-war consensus. Despite initially promising a "quiet revolution" in the government's

¹³ de Vries, *Cooperation on Trial* pp. 439-441

¹⁴ Benn *Office Without Power* p221; Jenkins *A Life at the Centre* p291

¹⁵ Sandbrook, *White Heat* p780

¹⁶ This was a reference to the Selsdon hotel in which the Tories had formulated their policy but also to the prehistoric hoax Piltdown Man. The implication was that these policies were unsuitable to modern Britain Christian Caryl *Strange Rebels: 1979 and the Birth of the 21st Century* (New York: Basic Book, 2014) p57

¹⁷ Andy Beckett *When the Lights Went Out What Really Happened to Britain in the Seventies* (London: Faber and Faber, 2009) p31

economic management, Selsdon Man turned out to be “somewhere between a breathless exaggeration and a malicious fiction,” in Andy Beckett’s phrase.¹⁸

A brief overview of Heath’s domestic policies demonstrates that, an initial period of innovation notwithstanding, Heath responded to economic challenges with the traditional policies of the post-war consensus. Most notable was the ‘U-turn’ on the commitment to pursue a more laissez-faire industrial policy – letting “lame ducks” fail as it was known. With unemployment approaching the totemic 1 million mark in 1971 (see Figure 5.1), the Conservative government instead bailed out Rolls Royce and Upper Clyde Shipbuilders rather than letting them go under.¹⁹ Relations with the unions were soured by the Industrial Relations Act despite Heath’s genuine commitment to establishing a tripartite consensus between unions, employers and government.²⁰ Innovation in monetary policy, in the form of Competition & Credit Control which removed quantitative restrictions on bank lending, precipitated a surge in the money supply, property speculation and a secondary banking crisis in part because Heath’s government failed to abide by its own provisions on interest rates. Instead Heath kept rates low in an attempt drive growth and reduce unemployment while resorting to fresh controls on bank lending (see Figure 5.2).²¹

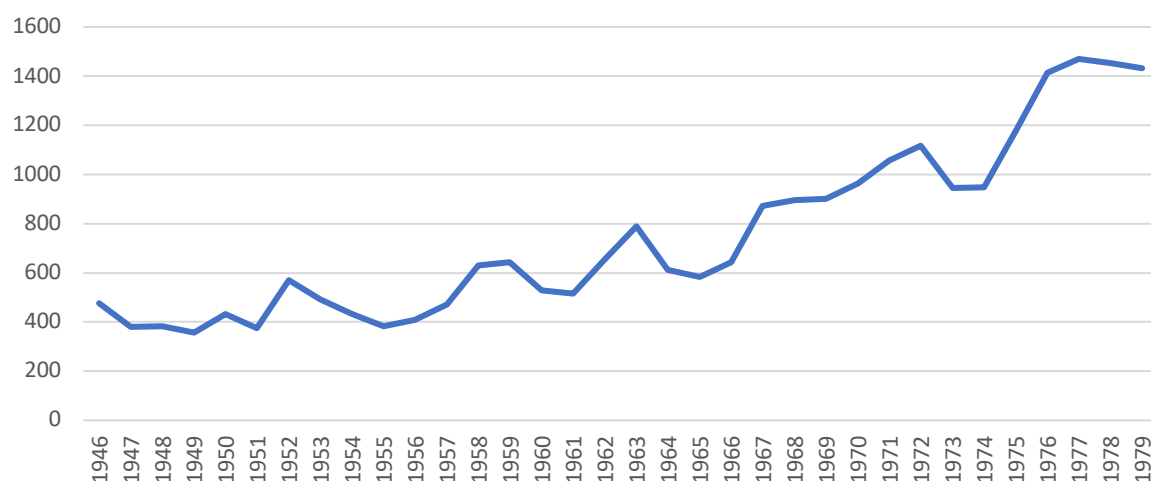
¹⁸ *Ibid* p31

¹⁹ Newton *The Reinvention of Britain* p83

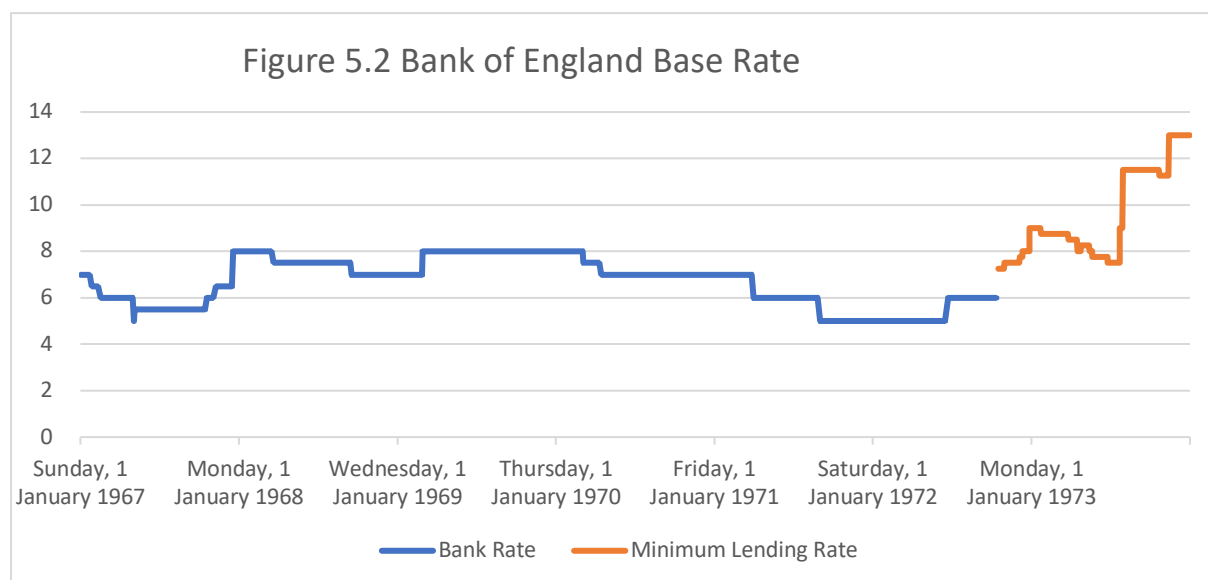
²⁰ *Ibid* p81

²¹ Forrest Cappie *The Bank of England: 1950s to 1979* (Cambridge: Cambridge University Press, 2010) p523

Figure 5.1: UK Unemployed (000s)



Source: Bank of England *A Millennium of Macro Economic Data* Table A.50 "UK labour market quantities 1855-2015, (000s)"



Source: Bank of England, "Changes in Bank Rate, Minimum Lending Rate, Minimum Band 1 Dealing Rate, Repo Rate and Official Bank Rate" [Online] <https://www.bankofengland.co.uk/-/media/boe/files/monetary-policy/baserate> (accessed 13 August 2019);

A more fundamental change was achieved in foreign policy, namely Britain's accession to EEC membership. Heath was fortunate that the retirement of de Gaulle in 1969 removed one of the major obstacles to British membership. Agreement was reached in January 1972 prior to Britain becoming a full member on 1 January 1973. The issue of sterling's reserve role briefly threatened to derail negotiations, in particular the danger posed by the sterling balances as well as the favourable

discrimination the Sterling Area received in Britain's system of capital controls.²² However the minister in charge of negotiating entry Geoffrey Rippon gave a commitment to "envisage an orderly and gradual run-down of official sterling balances after our accession," although without any firm details on how this was to be brought about.²³

The Rippon commitment, as it became known, placated the Europeans in part because sterling was stable prior to the Nixon Shock. The external environment in 1970 and the beginning of 1971 was benign.²⁴ Sterling had been stabilised thanks to the return to surplus in 1969. Britain was a beneficiary of capital inflows in response to a lowering of interest rates in America as Nixon leaned on the new Chairman of the Fed Arthur Burns to relax monetary policy.²⁵ £1250m flowed into the reserves between October 69 and March 70, as a result of renewed confidence in sterling and tight monetary policy.²⁶

There remained however considerable concern in Whitehall about sterling's future prospects. The repayment schedule of previous support rounds was a cause of concern. A memo in January 1970 noted that the debt burden was likely to be "uncomfortable in spite of continued surplus," with £1bn due to the IMF alone due to be repaid in June 1971.²⁷ Wilson's nemesis, the former Governor of the Bank of England Lord Cromer had appeared on *Panorama* two weeks before the election to argue the debt position meant any incoming government would face a more difficult financing situation than in 1964.²⁸ This overstated matters somewhat. Debts owed to the IMF and central banks had come down from \$8bn at the end of 1968 to under \$4bn by the time Heath arrived in power. By 1971 debts to central banks were paid off, as was the money owed to the IMF the

²² Schenk *The Decline of Sterling* p143

²³ *Ibid* p151

²⁴ Quoted in James *International Monetary Cooperation* p214

²⁵ Allen J. Matusow *Nixon's Economy: Booms, Busts, Dollars and Votes* (Lawrence: University Press of Kansas, 1998) p59 - 60

²⁶ TNA T318/360 "The inflow of funds" 05 March 1970

²⁷ TNA T312/2899 "IMF Refinancing" 09 January 1970

²⁸ David Kynaston *The City of London Vol.4 A Club No More 1945-2000* (London: Pimlico, 2002) p414

following year.²⁹ Nevertheless, Heath continued Wilson's policy of engaging with reform of Bretton Woods to secure the long-term stability of sterling. This meant there would be no dramatic changes in sterling's status. As a communication sent to finance ministers of the Sterling Area noted, the British government was not prepared to run down the reserve role of sterling "without having a clear idea of what to put in its place."³⁰

The Treasury under the new chancellor Anthony Barber was therefore enthusiastic in its adoption of the Special Drawing Rights [SDR], which had finally come into operation at the beginning of 1970.³¹ It was hoped that the SDR would become equivalent to gold or foreign exchange in a country's reserves and therefore soften the external constraint faced by countries pursuing expansionary policies. Accordingly, Britain was a front runner in its incorporation of the SDR into economic policy.³² However other countries were less enthusiastic and by the end of 1970 the Bank of England decided to vary its policy of using SDRs to pay IMF charges as the lack of any other meaningful SDR activity meant the UK's transactions were beginning to look rather conspicuous.³³

Likewise, Heath continued with the 1968 Sterling Agreements which had stabilised confidence in sterling among the OSA, thus reducing one source of pressure on the exchange rate at the cost of a build-up in balances themselves from £1.5bn in 1968 to £2.3bn at the end of 1970. SDRs complicated the matter as the arrangement had been drawn up before activation and therefore made no provision for it, while a number of important sterling holders such as Kuwait and Singapore were not participating in the scheme.³⁴ While he was still Chancellor in July 1969, Jenkins had written a letter to the OSA countries advising that although the UK intended to treat the SDR as a fully-fledged reserve asset, he did not intend to propose altering the Basle agreements until the

²⁹ Alec Cairncross "The Heath Government and the British Economy" in Stuart Ball and Anthony Seldon [eds.] *The Heath Government 1970-74 A Reappraisal* (London: Longman, 1996) p129

³⁰ Schenk *The Decline of Sterling* p144

³¹ TNA T312/2919 "Sterling Agreements and SDRs" 12 October 1970

³² TNA T312/2919 "SDRs and Money Supply." 19 October 1970

³³ TNA T312/2919 "Use of SDR and Gold" 04 November 1970

³⁴ TNA T312/3410 "Sterling Agreements: SDRs" 02 April 1970

1971 review when the option to extend them for another 2 years would be negotiated with participating countries.³⁵ Cautious not to rock the boat, the Treasury under the new Conservative Chancellor Anthony Barber continued this approach, on the assumption that the general lack of response to Jenkins' proposal indicated acceptance on the part of the OSA.³⁶ In March 1971 the Bank of England proposed to renew the exchange rate guarantees for another two years. Despite the instability caused by the Nixon Shock, by September 34 of 36 of the original participants had agreed terms.³⁷

Heath's government therefore initially sought to maintain the external framework that had had stabilised sterling under Wilson. As events were to prove however, the stability of the framework itself was ultimately determined by the attitude of the US government under Nixon towards the future of Bretton Woods.

5.3: Heath, Nixon and the Nixon Shock June 1970 – August 1971

Nixon's initial reaction to Heath's election was positive – according to his advisor on national security Henry Kissinger, Nixon was "elated" by the news. However, relations quickly deteriorated.³⁸ Despite being in favour of British membership of the EEC, Washington found British alignment with the French in monetary reform discussions irritating. In his memoirs, Kissinger described Nixon as a "jilted lover" in response to Heath downgrading the "special relationship" to merely a "natural relationship," based on historical, cultural and linguistic ties rather than any coordinated economic or political approach to policy.³⁹

³⁵ TNA T312/2919 "Sterling Agreements and SDRs" 9 October 1970

³⁶ TNA T312/2919 "Sterling Agreements and SDRs" 16 October 1970

³⁷ Cappie *The Bank of England* p413

³⁸ Alexander Spelling "Anglo-American Relations During the Nixon Years" (Unpublished PhD Thesis, University of Nottingham) p 7

³⁹ Henry Kissinger, *Years of Upheaval* (Boston: Little Brown, 1982) p141

Historians have tended to agree with this analysis. Alan Dobson has argued that Heath's European orientation and the lack of rapport between the two leaders resulted in a difficult relationship.⁴⁰ Britain's influence in monetary negotiations both before and after the Nixon Shock was constrained by the need to placate French opinion. Susan Strange argues that the key relationships during this period was between the US and Japan and the US and Germany with Britain "powerless even to act as intermediary between France and Germany."⁴¹ Catherine Schenk agrees, noting that "throughout these discussions the relationship between the UK and US was never very close or influential," and that the US expected British freedom of action to be restricted until the EEC application was accepted.⁴² This weakening of the Anglo-American relationship also reflected a divergence in interests. As Stephen George has argued, Heath's strong support for entry to the EEC was a reaction to the changing world context of the early 70s, which was itself partly driven by American policies.⁴³ From the perspective of this thesis, the divergence of interests expressed itself in differing objectives for international monetary reform. Both countries expressed concern in 1970 over the growth in short term capital flows. The British abandoned the basic balance as a means of calculating the deficit or surplus on the external account and adopted instead the total currency flow methodology which took into account short term capital movements.⁴⁴ However while the Americans called for wider bands around parity and more frequent changes in exchange rates in response to capital flows in order to secure more prompt adjustment, the British, prioritising stability, believed these proposals would serve only to encourage greater short term flows.⁴⁵ This conflict was made public at the 1970 IMF Annual Meeting in September at which Barber spoke out against floating exchange rates. Delivered to an audience of finance ministers and central bankers it was "like a sermon against

⁴⁰ Alan Dobson, *Anglo-American Relations in the Twentieth Century: The Policy and Diplomacy of Friendly Superpowers* (Basingstoke: Routledge, 1995) p. 140.

⁴¹ Susan Strange "The Dollar Crisis 1971" *International Affairs* (1972) Vol. 48 (2) p214

⁴² Schenk *Decline of Sterling*, p326

⁴³ Stephen George *Britain and European Integration Since 1945* (Oxford: Basil Blackwell, 1991) p53

⁴⁴ Chalmers *International Interest Rate War* p27

⁴⁵ FRUS 69-76 Vol. 3 "Memorandum of a Conversation" 3 May 1970

atheism before a convocation of bishops,” according to Robert Solomon of the US Treasury.⁴⁶ Barber also envisaged existing holdings of foreign currencies being converted into SDR “on a considerable scale.”⁴⁷

While the British focused their efforts on securing reform to Bretton Woods’ provision of liquidity with which to manage the sterling overhang, the Americans were more concerned with adjustment. Like sterling, the dollar suffered from what Harold James has described as “the clash of national economic regulation with the logic of internationalism.”⁴⁸ However the systemic importance of the dollar to Bretton Woods meant that this clash was to have global implications. Under the *n-1* pattern of parities in which exchange rates were pegged to the dollar, it was believed the dollar was unable to devalue to restore competitiveness. Their top concern was therefore effecting adjustment on surplus economies like Germany and Japan.

The major card in their hand was the convertibility of the dollar. If the dollar-gold link was broken, the holdings of dollars that surplus economies had accumulated rather than appreciate their currencies would no longer have any claim on American reserves.⁴⁹ The idea of ending dollar-gold convertibility was not a new one. Paul Volcker, the Undersecretary for Monetary Affairs at the US Treasury, had first raised the issue upon Nixon’s inauguration in 1969. By 1971 the sustained American deficit meant the problem had become even more pressing and Volcker took the opportunity of briefing his new boss John Connally to raise the issue again. In the paper “Contingency Planning: Operations for the International Monetary Problem,” Volcker pointed out foreign holdings of dollars now amounted to \$24bn while US assets had dropped to \$14bn - of which \$11bn was gold. Volcker knew that a rise in interest rates to shore up confidence in the dollar would be unacceptable due to the upcoming election, so proposed a realignment of 15% for the

⁴⁶ Robert Solomon *The International Monetary System 1945 – 1976 An Insider’s View* (New York: Harper & Row, 1977) p175

⁴⁷ Cairncross “The Heath Government and the British Economy” p131

⁴⁸ James *International Monetary Cooperation* p207

⁴⁹ Barry Eichengreen *Exorbitant Privilege The Rise and Fall of the Dollar* (Oxford: Oxford University Press, 2011) pp. 61-62

deutschmark and yen. To bring this about Volcker proposed a “cold blooded” suspension of convertibility.⁵⁰ This position was supported by the NY Fed which saw it as preferable to long, drawn out negotiations over currency realignments.⁵¹

The prospects for the dollar were unlikely to be boosted by the administration’s domestic policies. Nixon’s 1971 \$11.6bn budget deficit was compounded by leaning on the Fed to lower interest rates. Burns responded by pumping up money growth to the fastest rate since the war.⁵² The decline in American rates coincided with a rise in Germany and although rates moved closer in April, by this time speculators had read the writing on the wall and were betting on further currency realignments.⁵³

For those speculating against the dollar, the deutschmark was the key currency. The German government was reluctant to re-value the currency as it would undermine the vital export sector. Nor, given the rise in wages and prices and deficit in the basic balance (i.e. excluding short term capital flows), did they believe it was justified.⁵⁴ However, capital inflows masked the ‘correct’ exchange rate based on German’s external position and created a self-fulfilling prophecy in favour of revaluation. By the beginning of May the situation had become untenable for the Germans. \$2bn was taken in the first forty minutes of trading on 5 May prompting the closure of foreign exchange markets.⁵⁵ The Germans appealed to the EEC to take joint action on the basis of “community spirit” but their proposal that all members cease intervention against the dollar sat uncomfortably with the existing agreement to narrow margins of fluctuations within Europe – currently planned to take place on 15 June – as a prelude to monetary union.⁵⁶ In particular, the French resisted the German proposals, fearing that the franc would be dragged up by speculative flows into the Deutschmark,

⁵⁰ William L. Silber *Volcker: Triumph of Persistence* (London: Bloomsbury, 2012) pp. 27 - 78

⁵¹ FRUS 69–76 Vol.3 Editorial Note 22 March 1971

⁵² Matusow *Nixon’s Economy* p101 – 104

⁵³ de Vries *The International Monetary Fund 1966 – 1971 The System Under Stress* p 519 - 520

⁵⁴ *Ibid* p 520-523

⁵⁵ Oliver & Hamilton “Downhill from Devaluation” p504

⁵⁶ TNA FCO 30/952 “International Monetary Situation” 9 May 1971.

damaging attempts to restore a current account surplus and reduce unemployment.⁵⁷ In the meeting of EEC Council on the 9 June only the Dutch sided with the Germans. Instead of jointly floating, the meeting came to an uneasy agreement that the Deutschmark would float alone for a limited time until the crisis passed.⁵⁸

According to James, the capital flows of 1971 imposed a stark contrast on countries: float the currency or impose capital controls along the French lines. The unhappy American experience of controls under Johnson in the 1960s, and Nixon's campaign commitments to liberalisation meant floating emerged "as the only answer to systemic crises."⁵⁹ At this point however, floating was only envisaged as a transitional method of adjustment. When French Finance minister Giscard D'Estaing met Connally and Volcker towards the end of May, the Americans stressed their endorsement of greater flexibility did not imply full floating and envisaged a return to more stable rates once the crisis had passed.⁶⁰

While the Europeans were deliberating their joint float, a Volcker paper argued the present crisis offered an opportunity for the Americans to secure a turnaround their balance of payments and long-term reform of the international monetary system. According to the paper, US defence and aid spending meant the external account was in fundamental disequilibrium at the present pattern of exchange rates. The paper argued for a more equitable division of defence and aid spending between America and its allies, phasing out gold from international payments and multilateral realignment of exchange rates. These had been the key American objectives for several years; the Volcker group argued that they could now be achieved if the US was willing to exploit such crises to its advantage.

⁵⁷ TNA FCO 30/952 "Franco German Differences on How to Deal With Inflation" 3 May 1971

⁵⁸ TNA FCO 30/952 "International Monetary Situation" 9 May 1971

⁵⁹ James *International Monetary Cooperation* p224 - 225

⁶⁰ FRUS 69-76 Vol. 3 "Memorandum of a meeting" 20 May 1971

Tactically, the Volcker group endorsed a policy of ‘benign neglect.’ The US would allow foreign exchange crises to develop without intervention, forcing the Europeans to choose between dollar inflows or allowing their currencies to appreciate. At “an appropriate time” the US would indicate its own solution, potentially suspending gold convertibility and/or instigating trade restrictions to gain leverage in negotiations. Floating could be tolerated “indefinitely,” although at this stage such an idea was a bargaining tactic to force concessions from the Europeans rather than a definitive American policy.⁶¹ The US would resist pressure to raise the price of gold, with Connally comparing it to the Munich Settlement. The American’s preferred solution to Bretton Woods’ liquidity problem remained SDRs, into which they proposed to convert excess foreign holdings of dollars.⁶²

Fittingly, Connally made a speech on the future of Bretton Woods in Munich on 12 May, lobbying for greater burden sharing between the US and her allies:

No longer can considerations of friendship, or need, or capacity justify the United States carrying so heavy a share of the common burdens.⁶³

Volcker pushed for a paragraph on introducing greater flexibility into Breton Woods, but Connally amended it to “make it abundantly clear that we are not going to devalue, we are not going to change the price of gold, we are going to control inflation.” When Volcker asked his boss whether Connally wanted to make the point so strongly, given that America might have to pursue such a policy before too long, he replied “That’s my unalterable position today. I don’t know what it will be this summer.”⁶⁴

Connally’s views indeed evolved over the summer of 1971. After reading a report stressing the job benefits of a dollar devaluation, he submitted a memo to Nixon on 2 August proposing wage and price controls, tax cuts and – most significantly for the global economy – closing the gold window,

⁶¹ FRUS 69-76 Vol. 3 "Paper Prepared in Department of the Treasury" 8 May 1971

⁶² FRUS 69-76 Vol. 3 "Paper Prepared in Department of the Treasury" 9 May 1971

⁶³ FRUS 69-76 Vol. 3 Editorial note

⁶⁴ Paul Volcker & Toyoo Gyohten: *Changing Fortunes The World’s Money and the Threat to American Leadership* (New York: Three Rivers Press, 1993) pp.74-75

the first time a Secretary of the Treasury had endorsed such a policy. Nixon agreed, looking for a bold and decisive policy in the economic field and set the date for 8 September, the day Congress returned from summer recess.⁶⁵

Events in foreign exchange markets were to force Nixon's hand. A Congressional sub-committee on international payments had released a report on 6 August that concluded the dollar was over-valued and that the US would soon have to suspend gold convertibility, provoking movement out of the dollar despite a Treasury statement that the report did not reflect Congressional opinion, or that of the administration.⁶⁶ Volcker warned that in response to the renewed speculation against the dollar any initiative involving suspending gold convertibility as part of a considered and constructive reform package could not wait until September. Connally forwarded the message onto Nixon who decided on a "big, bold" approach and decided to repair to Camp David to thrash out the details.⁶⁷

The British were not considered throughout these decisions, but one action was to have an impact on American policy. A British request for cover on some of its dollar holdings was misconstrued by the Americans who thought they were being asked to find \$3bn rather than \$750m.⁶⁸ Solomon argues that the British request was "no more than an irritant."⁶⁹ Volcker affirmed that the decision to close the gold window had been taken prior to the British request, but noted the symbolism:

If the British, who had founded the system with us, and who had fought so hard to defend their own currency, were going to take gold for their dollars, it was clear the game was indeed over.⁷⁰

This was a complete misreading of the situation; Britain remained committed to cooperative defence and reform of Bretton Woods, while it was the Americans who were preparing to depart

⁶⁵ Matusow *Nixon's Economy* p148

⁶⁶ Jeffery A. Frieden "Economic Integration and the Politics of Monetary Policy in the United States" in Robert O. Keohane & Helen V. Miller [eds.] *Internationalization and Domestic Politics* (Cambridge: Cambridge University Press, 1996) p123; FRUS 69-76 Vol.3 "Editorial Note" 1 August 1971

⁶⁷ Volcker, *Changing Fortunes* p76

⁶⁸ Solomon *The International Monetary System 1945 - 1976* p185

⁶⁹ *Ibid* p185

⁷⁰ Volcker, *Changing Fortunes* p77

from this established practice. As Harold James described Nixon's announcement of the measures on 15 August 1971, "Richard Nixon spoke exclusively the language of national power and national advantage. International cooperation appeared suspect; international agencies futile."⁷¹ Nixon's announcement of the measures stressed the America-first nature of the policy:

If you want to buy a foreign car or take a trip abroad, market conditions may cause your dollar to buy slightly less. But if you are among the overwhelming majority of Americans who buy American-made products in America, your dollar will be worth just as much tomorrow as it is today.⁷²

Nixon's comments were remarkably like Wilson's over devaluation in 1967, however the reaction he received was very different. A New York Times editorial congratulated the President for his "boldness," while the Dow Jones Index rose 33 points.⁷³ Nixon's move had shored up support for his economic policies at home, while firmly knocking the ball of international monetary reform into the Europeans' court.

5.4: The British Response - August 1971 – September 1971

The Nixon Shock posed a dilemma for the British. The unilateral nature of the American move as well as Heath's determination that Britain should respond as a European power, particularly while the third application for membership of the EEC was underway, meant that Britain would align with France during the contentious debates that followed. On the other hand, Britain's interests in monetary reform, most notably the liquidity question and the future of foreign currencies as reserves, meant Britain believed the crisis unleashed by the Nixon Shock could also prove cathartic in achieving meaningful change.

Britain's own national interest was also in preserving the competitiveness of sterling. With the current account in surplus, it was likely the US would seek some form of revaluation with respect to

⁷¹ James *International Monetary Cooperation Since Bretton Woods* p209

⁷² Richard Nixon "Address to the Nation Outlining a New Economic Policy: "The Challenge of Peace". The American Presidency Project [online] <https://www.presidency.ucsb.edu/> (accessed 13 July 2013)

⁷³ *New York Times* 16 August 1971

the dollar. However, Heath and his government were aware that the prospect of sterling over the medium term was less rosy. The domestic economy was in the doldrums, although the extent of recession in 1970 was overstated in initial output data. In his 1971 budget Barber unveiled further tax cuts and easier credit with the aim of driving up consumption. A prescient Samuel Brittan noted the likely outcome of the budget was a balance of payments crisis between 1972 and 73.⁷⁴

The progress of the Barber Boom (as it became known) highlights one of the central arguments of this study, namely that the external constraints imposed on the operation of the British economy shifted with the evolution of the world's monetary system and the terms of Britain's engagement with it. The experience of the previous decade in which 'stop-go' economics had supposedly sacrificed domestic expansion to the need of defending the parity (and Bretton Woods) meant interest in floating exchange rates had spread from academia to both sides of the political spectrum. The Nixon Shock had undermined the normative commitment of Bretton Woods towards pegged exchange rates and had opened policy space for floating rates, as demonstrated by the experience of the DM since 1969. Rates were floating in the immediate period following the Nixon Shock, before a new system of parities was patched up at the Smithsonian Agreement in December. However, Nixon had fatally undermined the commitment towards parities and Britain became reluctant to impinge on the progress of domestic growth in the name of exchange rate stability.

Nevertheless, the problem of the sterling overhang remained. The danger was diversification on the part of the holders could effectively sink the floating rate, requiring extreme measures such as blocking the balances and retreating behind a wall of controls. While floating sterling could evade the rigid distortions of Bretton Woods adjustment, managing confidence in sterling balances continued to be a priority in shaping the external constraint. While the Basle guarantees stabilised these in the short term, resolving them definitively required financial firepower. With the turn to unilateralism on the part of the Americans, Europe now looked the best bet. This was the opinion of

⁷⁴ Quoted in Stewart *Politics and Economic Policy in the UK Since 1964* p132

Lord Cromer, now ambassador to the US, who counselled perspective on the unilateralism of the Nixon Shock - "I would think it would be a mistake to react too tragically to the lack of prior consultation. No major power has an immaculate record in this respect," but went on to make an objective assessment for moving the UK closer to Europe:

[The] Americans no longer consider it necessary to consult with the UK as an imperial or World power. They consult with us when it is useful to them and not because they have to. Secondly it would appear that the old concept that the dollar and sterling should stand together as the two major world trading currencies is now obsolete. Sterling is not of the importance that it used to be; the dollar alone really matters. With the dissolution of the Sterling area, the power and the influence which went with being the centre of it has disappeared. It is perhaps a back handed compliment to HMG that Sterling is currently so strong that the Americans evidently had no fear of precipitating a Sterling crisis by their measures. All this contributes powerfully to the argument of a need of a European monetary bloc on a scale that signifies.⁷⁵

The major challenge facing Europe was that the breakdown of Bretton Woods introduced a paradox into European monetary relations. On the one hand, the large volumes of liquidity moving around the world called for more exchange rate flexibility to cope – either wider margins around pegs or floating exchange rates. However, the drive to European integration called for restricting exchange movements between European currencies, both as a basis for monetary integration and for management of the Central Agricultural Policy [CAP].⁷⁶

The two objectives – reduced flexibility between European currencies and greater flexibility with the rest of the world – were not necessarily irreconcilable. They would however require commitment of the stronger currencies to provide resources to support weaker currencies. This would not be forthcoming until the 1990s with what Harold James has called the "Europeanisation" of the Bundesbank – the widespread acceptance of the German model of central banking in which the over-riding objective was price stability. With most central banks of the 1970s focused on full

⁷⁵ TNA PREM 15/309 "International Monetary System" 15 August 1971

⁷⁶ Hubert Zimmerman "The Fall of Bretton Woods and the Emergence of the Werner Plan" in Lars Magnusson and Bo Strath [eds.] *From the Werner Plan to the EMU: In Search of a Political Economy in Europe* (Brussels: Peter Lang, 2002) p68

employment, this meant no such support would be forthcoming from the Germans on the scale required to stabilise fluctuations between European currencies.⁷⁷ The implication for the British over the medium term was, as we shall see, a return to America as the major source of funding for sterling, albeit less easily obtained than in the 1960s as changes in the international monetary system that began with the Nixon Shock enabled the US to more effectively insulate both itself and the global economy from sterling crises.

The first Anglo-American contact following the Nixon Shock took place on a tour made by Paul Volcker in August of European capitals and Japan. Prior to this, Heath and Barber had met with senior Treasury officials to discuss the British response to the crisis. In the short term, the British would seek to mitigate any rise in sterling during the anticipated realignments in currencies. In the longer term, they would throw their weight behind reforms of Bretton Woods that would reduce the role played by reserve currencies in providing liquidity. Now that the dollar was unconvertible (except, like sterling, into other currencies), it seemed a propitious time to consider how to phase out the sterling balances via international reform. However, it was also decided that British policy was to be formulated in concert with the Europeans as British entry to the EEC remaining the primary objective throughout the crisis.⁷⁸ The contradiction between these last two objectives hindered the effectiveness of British influence over reform and positioned the French as America's principal partners in reform discussions.

The meeting with Volcker was also attended by representatives of the major European treasuries and central banks. Volcker opened by outlining the American reasons for the dramatic change in policy. Domestically, Nixon had been prompted by rising unemployment and the disappointing record on inflation. On the external front, the persistent deterioration of the balance of payments demanded radical action. Volker acknowledged that the domestic measures alone might have

⁷⁷ See Harold James *Making the European Monetary Union* (Cambridge: Harvard University Press, 2012)

⁷⁸ TNA PREM 15/309 "Note of a Meeting at 10 Downing Street at 11:20 AM" 16 August 1971

“stopped the rot” for a few months while gold convertibility remained in place (a position that had been favoured within the administration by Burns) but denied this could have succeeded in the long run. Volcker explained the US expected a turnaround in its balance of payments in addition to long term reform of Bretton Woods but was remained adamant at this stage that there could be no change in the official price of gold.⁷⁹

The British delegation had been briefed by Heath to push for an early meeting of the Group of Ten, but Volcker poured cold water on the idea by arguing that such a meeting should not occur until the ground had been thoroughly prepared. Morse of the Bank of England queried the American timetable for reform, noting that Volcker seemed to envisage a period of weeks or even months before a return to fixed parities, raising the threat of a return to generalised floating for the first time since the war. Volcker replied that the credibility problem currently undermining Bretton Woods meant that markets did not trust the established parities as they stood – in which case a period of market determination might not be a bad thing. Volcker was concerned that an early announcement on realignment would not last. Kirbyshire of the Bank retorted that market determination was undermined by the amount of dollars circulating the world’s financial system.⁸⁰

With no American concessions forthcoming, Heath formulated his response. The American plan had been left deliberately opaque but the general thrust of their demands – a realignment of currencies in which liquidity and convertibility would be based on the SDR – was not unwelcome to Britain, providing the terms could be settled favourably. However, the need to deal in concert with the Europeans remained paramount. Accordingly, the Heath government aimed for a joint float of European currencies against the dollar – thereby maintaining some stability in exchange rates while securing a commitment of European responsibility for the fate of sterling – but with the stronger German and Dutch currencies revalued first.⁸¹ Meeting with the EEC finance ministers towards the

⁷⁹ TNA PREM 15/309 “Note of a Meeting Held at 10 Downing Street at 7.50pm” 16 August 1971

⁸⁰ TNA PREM 15/309 “Memorandum of Conversation” 16 August 1971

⁸¹ TNA PREM 15/309 “Meeting with EEC Finance Ministers” n.d

end of August, Barber impressed on the Europeans the British desire to find a common solution to the crisis. However, the Six failed to agree a common approach between themselves, with Barber reporting disagreement over the level of “anti-Americanness” that should be adopted in the response.⁸²

The deputy finance ministers of the G10 met in Paris at the beginning of September, but no solution to the crisis was forthcoming. The British, mindful of their third EEC application, were careful to line up with her future European partners in pressing for a rise in the price of gold.⁸³ Volcker firmly resisted any such reform, while presenting the Europeans with the American objectives for realignment: a swing of \$13bn in the American balance of payments, to eliminate controls on capital outflow while still turning a small surplus. According to Volcker his European counterparts were “appalled,” as they realised the magnitude of realignment that would be required of their currencies to bring about such a turnaround.⁸⁴

Prior to the Paris Group of Ten meeting, Barber had met his EEC counterparts in Brussels in which he committed himself to a European solution, although differences between the Germans and French continued to preclude a common float. The French, for whom the CAP was the cornerstone of the European project, were generally opposed to floating, preferring elaborate exchange controls to deal with the crisis. The Germans, who had endured the worst of speculative inflows, advocated greater flexibility in dealing with the wider world. Barber followed by meeting with Giscard d’Estaing in Paris on 7 September at which they agreed that an early return to fixed parities (sterling had been floating since exchange markets had re-opened on 23 August) was unlikely, as was fixing parities between European currencies. Barber agreed to join the French led push for a rise in the price of

⁸² TNA PREM 15/309 "Note for the Record" Chancellor meets EEC finance ministers for consultations in Brussels. 19 August 1971

⁸³ Strange “The Dollar Crisis 1971” p205

⁸⁴ Volcker *Changing Fortunes* p81

gold, despite believing the chance of success to be low, given how much political capital Nixon had staked on the issue.⁸⁵

Heath's prioritisation of the EEC application is understandable given the importance membership had to British trade. However, this meant alignment with French in proposals for monetary reform to the detriment of British interests in this area, namely the issue of reserve currencies in international payments. As such the negotiation of an end to crisis and the prospect of a re-establishing Bretton Woods took place in the forum of Franco-American discussions revolving around French demands for a rise in the price of gold. This marked a dramatic loss of influence since the original Bretton Woods conference and meant Britain was unable to secure progress on reform that would resolve the sterling balance problem.

5.5 Negotiating a Return – September 1971 – December 1971

As negotiations moved into the autumn, the issue on both sides was whether progress would be secured as part of a grand bargain or a quick fix followed by a return to the incremental reform process that had characterised the period prior to the Nixon Shock. For the Americans, securing greater flexibility in adjustment as well as fairer burden sharing in aid and security took priority. Britain on the other hand remained concerned about the role of reserve currencies providing international liquidity. However American isolation over the impact of the import surcharge meant a softening of their position, initially behind closed doors. George Schultz, then director of the Office of Management and Budget and a friend of Milton Friedman, advocated making a bold stand on reform, rewriting Connally's IMF speech to back a system based on floating exchange rates although he was subsequently overruled.⁸⁶ Opposing this view was Arthur Burns, who wished to restore as much of Bretton Woods as possible. Burns advocated dollar devaluation through a change in the price of gold, and the restoration of gold convertibility based on a new alignment of currencies.

⁸⁵ TNA CAB 128/49/46 9 September 1971

⁸⁶ Allen Matusow *Nixon's Economy* p172

Nixon was critical of Burns, believing him to be too conciliatory towards the Europeans and sought to enlist Kissinger to prevent the formation of an anti-Connally faction, noting "Arthur wants to give away the store. Connally's standing firm." Kissinger however was increasingly concerned that bad feeling over the Nixon Shock was jeopardising America's other foreign objectives and sided with Burns. Confronting Nixon in November about the Secretary of the Treasury, Kissinger complained Connally was "like all Texans... just basically antiforeigner" and put his weight behind reaching a quick settlement.⁸⁷ As a result, the American position had softened by the time of the IMF Annual Meeting in September. Connally denounced gold once more but offered to remove the hated surcharge if other countries agreed to use floating as a transitional method to establish revalued parities against the dollar.⁸⁸

The British had some sympathy for this position but urged the Americans to go further. In his speech at the IMF, Barber recalled with gratitude the previous support the US had provided for Bretton Woods. On practical issues, he called for wider margins as a means of dealing with increased capital flows (contradicting the position he had taken the year before) and for a system of liquidity provision based on the SDR, arguing that the experience of the past few years had demonstrated the future did not lie with national currencies.⁸⁹

Barber's speech indicated that the British were favour of using the crisis to secure a wide-ranging reform, particularly one that involved resolution of the overhang that continued to threaten Heath despite the present stability of sterling. Nevertheless, there was a corresponding internal debate in Whitehall as to whether the best approach to the crisis would be to deal with exchange parities first before considering other issues or attempt to deal with all outstanding problems together in one grand reform. The Bank of England was in favour of focusing on exchange rates in the short run, believing any attempt to secure a grand deal in which all questions were settled simultaneously

⁸⁷ *Ibid.* p174

⁸⁸ TNA PREM 15/310 "Speech by Chancellor of the Exchequer to the Annual Meeting of the IMF" 28 September 1971

⁸⁹ *Ibid.*

would fail, provoking uncertainty in international trade and payments. This interpretation was challenged by Heath's economic advisor Brian Reading, who portrayed proponents of such a 'narrow front' approach as Cassandras who exaggerated the challenges of negotiating a wider deal.

According to Reading, an early restoration of fixed parities could not restore order to the monetary system since it was the fixed parities that were the problem in the first place. In Reading's opinion, only once a new and sustainable system of liquidity provision had been achieved could rates be restored to fixed parities.⁹⁰

The Treasury however sided with the Bank in its preference for an early deal on parities. Neale of the Treasury lambasted Reading's portrayal of narrow front proponents as a straw man, arguing those in favour of moving first on a realignment were only setting out the stages in which reforms were to be achieved⁹¹ Replying to Neale, Reading said he had in mind the Bank of England rather than the Treasury and conceded the possibility of an agreement on realignment that preceded a wider reform but judged it unlikely to succeed.⁹²

In hindsight, we can see the merits of both points of view. Reading was correct that fixed rates had become untenable given that the growth in short term capital flows, differential rates of inflation and size of the US deficit. However, the scale of the reform that the US had in mind, taking in not just a complete revision of Bretton Woods' adjustment, liquidity and confidence, but also trade, aid and security meant it was unrealistic to expect such a deal to be negotiated at once. Moreover, the need to prioritise Britain's application to the EEC meant Britain was unable to act as a constructive partner in securing such a reform. Barber was concerned that a global reform would be too difficult in the present circumstances and hoped for a coordinated European response. The key issue for Heath was where Britain wanted to be on 1 January 1973 (the date of its accession to the EEC). In an ideal outcome Heath envisaged a stable but competitive exchange rate and the sterling balances run

⁹⁰ TNA PREM 15/812 "Narrow front nonsense" 9 November 1971

⁹¹ TNA PREM 15/812 "Memo by AD Neale" 10 November 1971

⁹² TNA PREM 15/812 "Letter from Brian Reading to AD Neale" 16 November 1971

down to an extent where it was not necessary to discriminate between capital movements from the Sterling Area and Europe.⁹³

This confused debate – whether to proceed on a wide or narrow front regarding international reform, coupled with the need to consider the EEC application in formulating policy – meant Britain had little influence on the emerging agreement to restore parities at a revised gold price. Events were moving forward without British input. At the end of November, pressure was building within the White House to come to some form of settlement. After discussing with Schultz, Kissinger and Burns, Nixon agreed that Connally should now look for the best possible deal in return for removing the surcharge. The shift in American policy was first revealed during a ministerial meeting of the Group of Ten at the beginning of December. In response to a question on the price of gold during a discussion on exchange realignments, Volcker replied that such a change was not excluded, but dependent on the whole package of reforms. Connally jumped in impatiently: “All right, assume a 10% devaluation of the dollar against gold. What would you do?” which preceded a long silence.⁹⁴

Once the Europeans finally found their voices, the Germans expressed willingness to agree to a realignment of 12% while the Italians protested they could not take part in any realignment.⁹⁵ The British looked to secure the best deal for sterling, which they believed could extend to matching the dollar’s devaluation. However, they were forced to concede some form of change in parity regarding the dollar. Meeting with Heath after the Group of Ten meeting, O’Brien told the Prime Minister that the US would require at least a 7.5% devaluation of the dollar if it were to move on gold – the best the British could hope for was that sterling’s gold price would be unchanged.⁹⁶

It was decided a bilateral summit between Nixon and President Pompidou of France would be the best method of resolving the issues, meaning British proposals for liquidity reform were unlikely to

⁹³ TNA PREM 15/310 "International Monetary Situation" 03 November 1971

⁹⁴ TNA PREM 15/812 Record of Restricted Sessions (Finance Ministers and Governors Only) Of Meetings of the Group of Ten and of EEC Ministers on 30th November and 1st December 1971 in Rome” 1 December 1971

⁹⁵ Volcker *Changing Fortunes* p86

⁹⁶ TNA PREM 15/812 “International Monetary Situation” 13 December 1971

be given much attention.⁹⁷ Prior to the meeting, Heath sent a message to the French President in which he stated his support for a change in the dollar price of gold, new removals of tariff and non-tariff barriers and long term reform to reduce the use of national currencies in international payments. Heath however considered it unlikely Nixon would push for a large reform prior to his re-election in 1972 and therefore recommended opting for the quick fix: realignment of currencies in return for removal of the surcharge.⁹⁸

The summit itself at the Azores between Nixon and Pompidou saw agreement on the value of gold being changed from \$35 to \$38 per ounce (although dollar-gold convertibility was not restored) while committing to work towards a realignment of currencies. Pompidou lectured Nixon on the evils of the dollar standard while Volcker, Connally and Giscard d'Estaing sat in another room working out the main issues.⁹⁹ These realignments were agreed at a meeting of the G10 at the Smithsonian Institute in Washington the following week; by maintaining their gold parities, sterling and the franc effectively appreciated by 8.57% due to the increase in the price of gold. In addition, exchange rate margins were increased to 2.25% either side of parity to increase the flexibility of the system.¹⁰⁰ Nixon appeared unannounced on 18 December to hail "the conclusion of the most significant monetary agreement in the history of the world." Volcker was heard to retort "I hope it lasts three months."¹⁰¹

Volcker's concern was to prove justified. As Barry Eichengreen argues, the agreement failed to resolve the Triffin dilemma and brought only temporary relief to the dollar's competitiveness.¹⁰² The breakdown of the Smithsonian agreement began almost immediately. According to James, the continued weakness of the dollar due to the Fed's expansive monetary policy demonstrated the determination of the Nixon administration "not to let international considerations stand in the way

⁹⁷ Allen Matusow *Nixon's Economy* p175

⁹⁸ TNA PREM 15/326 "Letter from Heath to Brandt; also sent same letter to Pompidou" 26 November 1971

⁹⁹ Volcker, *Changing Fortunes* p88

¹⁰⁰ Solomon *The International Monetary System* p204 - 208

¹⁰¹ Allen Matusow *Nixon's Economy* p178

¹⁰² Eichengreen *Globalizing Capital* p131

of domestic economic objectives.”¹⁰³ To Gavin, this heralded the end of Bretton Woods, as the Smithsonian marked the last time that the US demonstrated commitment to fixed exchange rates and willingness to act as “caretaker of the global payments system.”¹⁰⁴

The most notable change was the American attitude towards international cooperation. Throughout the Bretton Woods period, America had judged its wider geopolitical interests (namely containing the Soviet threat) best served economically through the cooperative framework of institutional based intermediation in adjustment and liquidity. While the IMF continued to play an important role (as would be demonstrated in 1976), influential voices within the Nixon and Ford administrations, now took a more confrontational approach towards the reconstructed European and Japanese economies they believed were not pulling their weight in matters of trade, aid and security. They accordingly looked to more market-led intermediation in which floating exchange rates and an unconvertible dollar standard helped finance American hegemony and restored the dollar’s competitiveness.

5.6 Attempts at Reform *January 1972 – May 1972*

These developments were of course not immediately apparent. The realignment of parities agreed at the Smithsonian was intended as a short run solution that would buy time while more intractable problems involving adjustment, liquidity and confidence were dealt with. The British looked to engage the Americans at the beginning of 1972 on questions of reform that, it was hoped, would resolve the problem of the sterling balances. Meanwhile, Heath’s expansionary domestic policies (see below) raised the prospect of a return to sterling instability. It was the failure of any meaningful progress in Anglo-American discussions that prompted Heath looked to Europe as a surrogate system of support, although his refusal to accept any discipline or conditionality meant little was forthcoming.

¹⁰³ James *International Cooperation* p238

¹⁰⁴ Gavin, *Gold Dollars and Power* p196

Undoubtedly Anglo-American relations had been strained during the period following the Nixon Shock as American unilateralism was exacerbated by Heath's pro-European response. In an attempt to rebuild bridges, Cromer was instructed to inform Kissinger that UK entry into Europe did not mean "off with the old and on with new" regarding America, merely that it was "essential for us at this time not to get out of step with our future European partners."¹⁰⁵

Both nations had a continued interest in monetary reform, although in the long run the end of the gold-dollar link removed a lot of the pressure on the US. While the Smithsonian agreement had seen progress on the issue of adjustment by re-establishing parities and widening the bands in which they fluctuated there had been little progress on liquidity. Britain's most important objective was to secure international control over liquidity via a modified SDR scheme so that foreign holdings of sterling could be consolidated on reasonable terms.¹⁰⁶ The strategy to achieve this, outlined by Cromer and agreed to by Heath, lay in confronting French "extremism," without openly siding with the Americans against the Europeans.¹⁰⁷ The French wanted greater controls on capital outflows, restored gold convertibility to instil discipline on the dollar and fixed exchange rates, at least between European currencies, in order to safeguard the CAP. They were suspicious of schemes to consolidate reserve currencies into SDRs believing they involved the international community assuming the debts of individual countries.¹⁰⁸ According to the British Ambassador in Paris, Sir Christopher Soames, they were cynical that the Americans would ever accept the disciplines and responsibilities of a "one world" system and accordingly looked to European monetary union in which to insulate the community from the storms raging outside.¹⁰⁹

The French position was diametrically opposed to the increasingly liberal position of the US, which favoured removals of restrictions on investment and capital flows, particularly after George Schultz

¹⁰⁵ TNA PREM 15 / 712 "Home (letter) to Washington" 5 November 1971

¹⁰⁶ TNA T312/3006 "International Monetary Reform: Points for Presentation to the US Administration" 1 March 1972

¹⁰⁷ TNA PREM 15/812 "Telegram from Cromer to Barber" 8 May 1972

¹⁰⁸ TNA PREM 15/813 "Letter from Pompidou to Heath" 7 July 1972

¹⁰⁹ TNA PREM 15/813 "The EEC, International Monetary Reform and EMU." 18 July 1972

took over as Secretary of the Treasury in 1972.¹¹⁰ From the American point of view, the US deficit was the result of other countries' refusal to let them return to balance by running sustained surpluses while protecting their own markets from US competition. Accordingly, they looked to reform the monetary system to bring adjustment pressures onto surplus countries. This meant that once the dollar had achieved a greater degree of competitiveness following successive devaluations in 1973, US would lose interest liquidity reform as they continued to enjoy the benefits of issuing a reserve currency. Anglo-American interests also diverged due to the application for EEC membership which would place the British economy behind the EEC's common external tariff, effectively discriminating against US trade.¹¹¹

Although these diverging interests placed Britain in a difficult position, when Heath and Nixon met at the end of 1971 at Bermuda there was however optimism within some quarters of the British press that a rapprochement might be at hand. One article in *The Guardian* claimed the Bermuda summit represented a new chapter in Anglo-American relations and an end to the 'uneasy client status' to which the 'special relationship' had degenerated.¹¹² In monetary relations however there was little progress. Heath complained to Nixon that the IMF was too slow in facing up to the issue of monetary reform, which was of interest to the UK as it tried to mitigate its obligations as a reserve currency.¹¹³ With the short-term question of alignment supposedly settled by the Smithsonian agreement, Barber took the opportunity to press for progress on wider ranging reform, particularly on the question of liquidity and reserve assets. Connally however was not impressed, expressing doubt whether the SDR could command the support required for it to form the basis of the world monetary system.¹¹⁴

¹¹⁰ TNA T354/147 "Speech by Volcker international Finance and Monetary Reform Sessions of the National Foreign Trade Convention" 13 November 1972

¹¹¹ FRUS 69-76 Vol. 3 "Volcker Group Paper" 27 April 1972

¹¹² Spelling "Anglo-American Relations" p138

¹¹³ TNA PREM 15/1269 "record of a meeting at government house, Bermuda, on Tuesday 21 December at 10am" 22 December 1971

¹¹⁴ TNA PREM 15/1269 "Note of a meeting at the Princess hotel, Bermuda. On Monday 20 Dec 1971 at 2:30pm" 21 December 1971

Lack of enthusiasm on the part of the US towards British objectives in reform meant Heath increasingly looked to Europe as a surrogate source of support. With British membership agreed in February 1972, hopes were raised that prospective European monetary union might be able to secure the long-term viability of sterling.¹¹⁵ As Brian Reading argued, the Smithsonian agreement, including the price at which America “might refuse to buy and sell gold” were “mere palliatives,” while dollars continued to flood the world. Only lasting reform on liquidity would restore security to the system and for sterling.¹¹⁶ The British attempted to impress on their new European partners the need for urgency. Courting the traditional French desire to play an independent role in world affairs, Heath argued that the effective American “abdication” from the position of leadership in monetary reform presented the EEC with the initiative. The French however were more concerned with stability in exchange rates and therefore urged the Americans to intervene in support of the dollar as a first step before restoring convertibility, neither of which had much attraction to Washington.¹¹⁷

For their part, the Americans were reluctant to state definite proposals prior to the 1972 Presidential election, in case it sparked instability in the world economy or engaged Nixon in protracted debates with his European counterparts.¹¹⁸ At a speech to the Council of Foreign Relations in March, Connally justified holding back on American proposals for reform until agreement had been reached on the desired world economic order. Connally used his speech to challenge the Europeans to announce their own vision, in particular whether Europe itself would become a “liberalising and stabilising force” or descend into an “inward looking, defensive bloc.”¹¹⁹ Despite the challenging tone, a telegram from the British embassy in Washington assured the Treasury that it was an “epitome of reasonableness” compared to a first draft which proposed to lambast Cromer and Giscard d’Estaing for recent references to dollar convertibility.¹²⁰

¹¹⁵ TNA PREM 15/812 "Letter from Cromer to Heath" 26 February 1972

¹¹⁶ TNA PREM 15/812 "Back to Square One?" 6 February 1972

¹¹⁷ TNA PREM 15/812 "Telegram from Paris No. 355" 3 March 1972

¹¹⁸ TNA T312/3006 "Note for the Record: Visit to New York" 18 February 1972

¹¹⁹ TNA T312/3006 "Tel No 913" 15 March 1972

¹²⁰ TNA T312/3006 "International Monetary Situation US View" 16 March 1972

Instead of meaningful progress, debate centred over the correct forum for discussions on reform. Traditionally the Group of Ten had been used to agree reforms such as the General Agreement to Borrow, but the US were concerned the Europeans were over-represented and pushed for less developed countries [LDCs] to be included in order to mitigate the anti-American tone.¹²¹ The logical choice was the IMF but the US also distrusted the Fund's supposed institutional bias (since the Managing Director is traditionally European) and doubted whether they would be able to link trade and monetary questions under the aegis of the Fund.¹²² The Americans therefore proposed a new grouping – the Group of Twenty – that corresponded to the regional composition of the Fund. The group was established at conference in London in April, despite the objections of Cromer who argued that the group would undermine the Fund by interposing between the Managing Director and his staff a new committee with its own chairman.¹²³

In the meantime, the US policy towards the dollar remained one of benign neglect. Naturally such a strategy did nothing to endear the Americans to the French. So concerned was Pompidou with the effect loose American monetary policy was having on international exchange rates that he wrote to Nixon personally, urging him to adopt more appropriate policies.¹²⁴ As a Foreign Office official noted, while the main concern for the British was restoring a viable system of trade and payments, with due regard to stability, the French had it the other way round.¹²⁵ In return, the French viewed British proposals for liquidity reform as suspicious, coinciding as it did with American interests. Pompidou's support for an SDR order was conditional on some form of gold link without which he claimed it would have no intrinsic value.¹²⁶

The British were unable to stimulate American thinking on monetary reform. At a meeting between representatives of both countries' Treasuries in Washington at the beginning of March the British

¹²¹ FRUS 69-76 Vol.3 "Editorial note" 22 February 1972

¹²² TNA T312/3006 "Sir Alan Neale's Call on Mr Paul Volcker" 29 February 1972

¹²³ PREM 15/812 "Telegram from Cromer to Barber" 8 May 1972

¹²⁴ FRUS 69 - 76 Vol.3 "Letter from President Pompidou to President Nixon" 04 February 1972

¹²⁵ TNA T354/35 "International Monetary Reform: Discussion with French Officials " 28 March 1972

¹²⁶ *Ibid*

outlined their tentative reforms to their American counterparts. The heart of the British proposals was an improved version of the SDR which would act as the numeraire of the system on which all exchange parities would be fixed. Foreign holdings of currency would be consolidated into SDRs and all currencies would be convertible in this manner.¹²⁷ The American response was critical but they refrained from offering any constructive suggestions. Their focus was bringing adjustment pressures to bear on surplus countries as well as restricting other countries' unfair trading practices. They were also interested in the development of private capital flows, areas in which the British admitted they were lacking detail.¹²⁸

Lack of progress on reform undermined the commitment to the Smithsonian agreement. As we have seen, devaluation reinforced rather than weakened the commitment to the exchange rate peg. Floating had only been considered as a last resort in the Treasury's contingency plans (although opinion in parts of the Bank of England had been more favourable). This had been based on the understanding that Bretton Woods provided the best framework for stability in trade upon which British growth depended, while general reform offered the potential for easing the constraint imposed by the sterling balances. Despite the Nixon Shock, and the period of general floating it inaugurated, the attempt to re-establish parities at the Smithsonian reflected that the desire to continue with the process of reform had not vanished. However, the lack of any American initiative in this area undermined British commitment to the sterling peg. Domestic considerations as Heath attempted to expand the economy now took priority over international obligations.

5.7 The Sterling Float – April 1972 – June 1972

The floating of sterling in June 1972 took place within a reappraisal of British foreign economic strategy. On the one hand, the breakdown of Bretton Woods and with it the normative commitment to pegged exchange rates, coupled with the experience of 'stop-go' rounds of deflation over the

¹²⁷ TNA T312/3006 "International Monetary Reform: Points for Presentation to the US Administration" 1 March 1972

¹²⁸ TNA T312/3006 "Visit to Washington and Ottawa" 6 March 1972

previous ten years implied it would be better for the exchange rate itself 'to take the strain.' Floating exchange rates had attracted growing interest, initially in academic circles before spreading to the commentariat. There was appeal both to the right, who favoured market based determination of the rate, and the left who conversely believed it would free management of the domestic economy from placating market opinion, the famous 'gnomes of Zurich.' In contrast to his perception as 'Selsdon Man,' it was in fact this later motivation that drove the Heath government. With unemployment climbing, Heath was not prepared to see the economic boom initiated by the 1972 and 1973 budgets choked off by the need to defend the rate.¹²⁹ Thus by June 1972 there existed both the opportunity and motive to float the rate, in contrast to 1967.

Nevertheless, the problem of the sterling balances remained, and would continue to constrain economic policy even with a floating exchange rate. The lack of progress on general reform involving substitution through the SDR prompted Heath to seek alternative policies that would stabilise the balances and therefore reduce the constraint these imposed on sterling. As Cromer had suggested in his immediate response to the Nixon Shock, a common European monetary bloc now offered the most obvious source of support for sterling. Heath hoped that by committing to European monetary integration, sterling would secure a new source of unconditional support as part of a process of jointly pooling assets and liabilities. However, Heath's approach to national and international economic management was "highly inconsistent" according to James.¹³⁰ At the same time as making grandiose commitments to European monetary union, his domestic policies undermined the prospects of British participation. Ultimately Heath, unlike Wilson, truly went it alone, prioritising the growth of the domestic economy over all external considerations. These political commitments shaped the nature of Britain's external constraint, both permitting a more expansionary domestic policy though a floating rate but isolating sterling from sources of support.

¹²⁹ Beckett, *When the Lights Went Out* p127

¹³⁰ James *International Monetary Relations* p239

According to the Werner Report published in 1970, the first stage of European Monetary Union would require reducing exchange fluctuation between European currencies. However, under the Smithsonian agreement, parities had been widened to 4.5%. Since these were expressed in dollars, this meant two European currencies could move 9% in respect of each other, if one was at the top of its dollar parity and the other at the bottom. This was an unacceptable level of fluctuation, particularly to the French, for whom the CAP was a cornerstone of the European project and which would be jeopardised by large swings in European currencies. An agreement in Basle in April 1972 committed both the six existing members of the EEC and the three prospective members, including the UK, to limit currency fluctuations between them to +/- 2.25% either side of parity. This narrower band of fluctuation, operating as it did within the larger Smithsonian band became known as the 'Snake in the Tunnel.' As part of his European response to the breakdown of Bretton Woods, Heath committed sterling to joining within two months of the April deal.¹³¹

At the same time however, Heath was undermining the stability of sterling through domestic pump priming. The so-called 'Barber Boom' witnessed an unprecedented expansion of demand, followed in short order by an unprecedented balance of payments deficit. The boom had its roots in the unemployment figure hitting the emotional level of 1 million at the beginning of 1972. Heath also felt the economy needed stimulation to prepare it for the increased competition it would face following accession to the EEC on 1 January 1973. In his 1972 budget, Barber cut £1bn off income taxes, another £1.3bn from purchase tax, increased social benefits and pensions and unveiled a package aimed at encouraging investment, including regional investment grants and "free depreciation" for new investment in plant and machinery.¹³² The result was a predictable consumer boom, criticised by Edmund Dell for over-stimulating the economy and using up spare capacity that might otherwise be used in exports to countries that were themselves reflating.¹³³ However at the

¹³¹ Catherine Schenk *International Economic Relations Since 1945* (London: Routledge, 2011) p53

¹³² John Campbell *Edward Heath A Biography* (London: Pimlico, 2013) p445

¹³³ Dell *The Chancellors* p387

time the action was endorsed from all sides, with a whole spectrum of opinion from the TUC to *The Economist* magazine urging the government on.¹³⁴

Most notable in his budget speech was Barber's refusal to make a ritual declaration of commitment towards the sterling parity:

I am sure that all hon. Members in this house agree that the lesson of the international balance of payments upsets of the last few years is that it is neither necessary nor desirable to distort domestic economies to an unacceptable extent in order to maintain unrealistic exchange rates, whether they are too high or too low.¹³⁵

Although other fundamental factors also had responsibility for the sterling crisis that developed in June – notably a dock strike resulting from union discontent over government's Industrial Relations Act – this statement was symbolic in that it represented the view that managing sterling's external value would no longer be a constraint on domestic policy. A comment by Shadow Chancellor Denis Healey that sterling would soon be devalued exacerbated the situation, initiating the first sterling crisis since 1969.¹³⁶ The crisis was driven by movements in the sterling balances, particularly the Persian Gulf territories which had accumulated sterling assets exceeding their Minimum Sterling Proportion [MSPs] as a result of rising oil revenues.¹³⁷

As capital flowed out in June, the Cabinet discussed options for sterling. Devaluation was considered but rejected on the grounds that a small one would be ineffective while a large one would wreck the Smithsonian parities. Heath was reluctant to raise interest rates due to the effect this would have on his domestic boom. The decision to float therefore reflected the extent to which opinion had moved on since 1967.¹³⁸ But 1972 was not 1967. As Yeager noted, in a way the float was unprecedented -

¹³⁴ *The Times*, 16 March 1972

¹³⁵ *The Times* 22 March 1972

¹³⁶ Dell *The Chancellors* p389

¹³⁷ Schenk *Decline off Sterling* p337

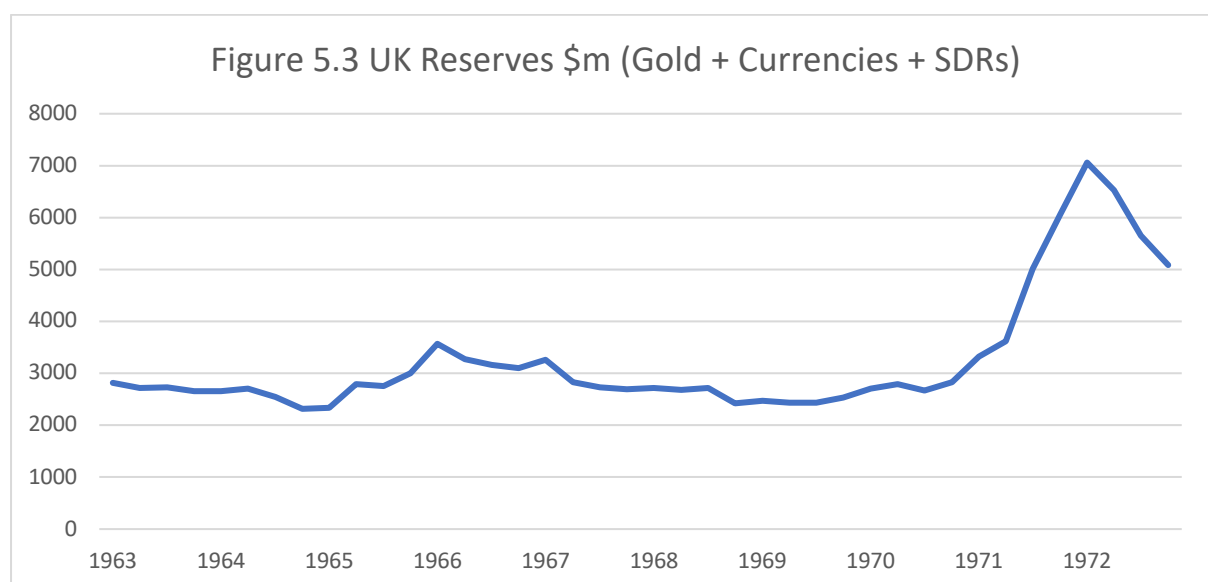
¹³⁸ Oliver & Hamilton "Downhill from Devaluation" p511

never before had a country abandoned support of its currency with such large reserves as Britain.”¹³⁹

This was a point raised at the time by Barber, who himself denied the situation was like 1967; the current account was in surplus and the Bank of England had substantial reserves (see Figure 5.3).

Rather, having just paid off its debt incurred from the previous bout of sterling instability, the British not want to incur fresh liabilities to defeat speculation for which they saw no objective basis. Heath put the point in these terms in his messages to President Pompidou and German Chancellor Willy Brandt justifying the decision, arguing:

We do not think it right indefinitely to spend our reserves, or to build up new international borrowing in order to finance these short-term swings of capital movements for which there is no justification.¹⁴⁰



Source: Bank of England *Quarterly Bulletin*, 1975 Q1 “Table 21: Reserves and related Items” Bank of England *Quarterly Bulletin* 1977 Q1, Table 23: Reserves and related items”; Bank of England *Quarterly Bulletin* 1979 Q1 “Table 16: Reserves and related items,”

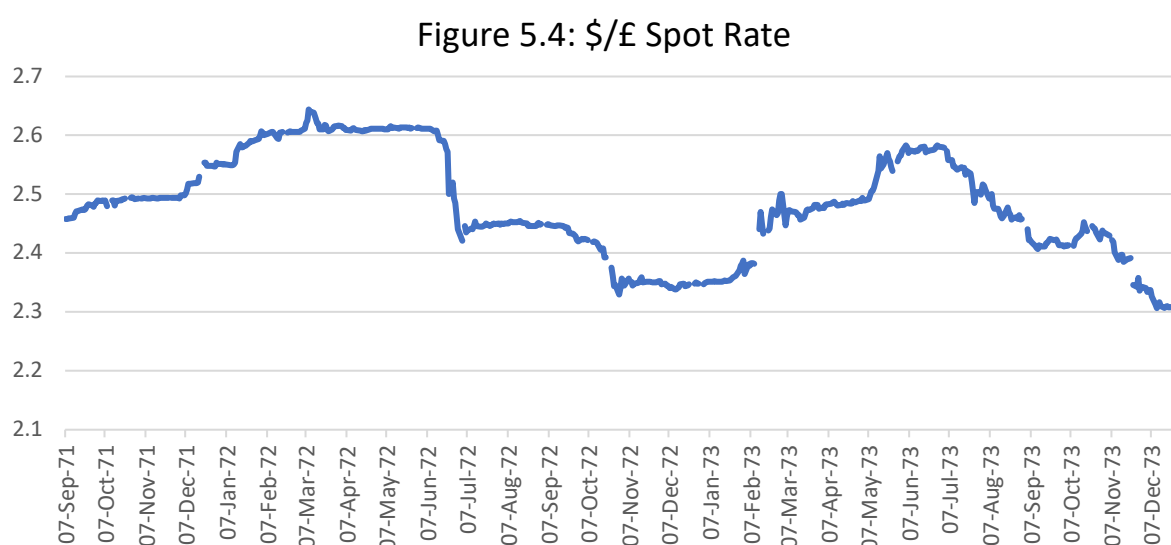
The decision to float was taken on 23 June. O’Brien, who was on holiday in Cannes at the time, was not consulted and awoke to the news that sterling had been floated.¹⁴¹ The immediate impact was 5.8% a depreciation in the rate to \$2.46 from \$2.61 on 12 June where it settled for most of the rest of the year, dipping slightly further to \$2.35 by the end of the year before rallying in response to a

¹³⁹ Yeager *International Monetary Relations* p467

¹⁴⁰ TNA PREM 15/813 "Telegram from Heath to Pompidou" 23 June 1972

¹⁴¹ Cappie *Bank of England* p711

new dollar crisis (see Figure 5.4). While the economic impact was therefore initially rather modest, floating did have significant implications for Britain's relationship with its economic partners. Heath had prioritised domestic autonomy over its international obligations, despite the unsettled nature of its relationship with America, Europe and the Sterling Area as well as the dubious prospects for reform. This was part of an attempt to manage the external constraint, securing greater flexibility in adjustment to facilitate more expansionary domestic policies while relying on economic diplomacy to secure the long-term stability of the sterling balances.



Federal Reserve, "G.5/H.10 – Foreign Exchange Rates" [Online] <https://www.federalreserve.gov/datadownload> (accessed 13 August 2019)

The decision to float sterling resulted in a transformation of the Sterling Area but took place without any plan for a corresponding transformation regarding the sterling balances. The breakdown of Bretton Woods had already weakened the links between the OSA and the UK. At the Smithsonian, several members including Australia, New Zealand as well as some developing countries had already ceased to peg to sterling. After sterling's float, most Sterling Area countries followed suit.¹⁴² During its application for membership of the EEC, Britain had eased controls over direct investment outside the sterling area as part of its commitment to end the sterling balances and facilitate intra-European investment. Now as part of the measures supporting the float of sterling, the British took the

¹⁴² *Ibid.* p711

opportunity to extend its system of exchange control to the entire OSA (excluding Ireland), effectively ending the Sterling Area.¹⁴³ The gradual erosion of the area's relation to the metropole meant its end became a "footnote to the retreat of sterling rather than a crucial element" in Schenk's phrase.¹⁴⁴

The sterling balances however remained a problem and were likely to become more so now that another bond had been broken with the holders, following on from Britain's military withdrawal east of Suez. The exchange guarantees under the 1968 Sterling Agreements had been renewed for 2 years in August 1971, with the Treasury arguing that had they not been in place diversification of OSA holders could have sunk the pound, with disastrous consequences for the government's inflation policy. However due to the attractive terms of the agreement, £800m was currently being held in excess of MSP and could be switched into other currencies. Floating complicated the matter as fluctuations in the rate could temporarily bring sterling's value underneath the guaranteed rate and raised prospect of having to make compensation payments on top of the high interest rates.¹⁴⁵ Therefore Britain ended its commitment to the sterling area without any final resolution of its liabilities, leaving it dangerously exposed in the years to come. Nevertheless, the balances themselves would not become a problem until 1975, following a further build up resulting from the OPEC oil shock.

Within Europe, the French were particularly affronted by the decision to float sterling. According to the British ambassador in Paris, they took a "rough attitude" to the decision, believing Heath had reneged on his commitment to Europe in joining the Snake.¹⁴⁶ Pompidou's response to Heath's initial notification was coldly civil in which the French President "took note" of the British intention to return to a fixed parity which he then went on to extoll as one of the "essential conditions for the proper functioning of the Common Market." He subsequently let it be known through the British

¹⁴³ Schenk *Decline of Sterling* p340

¹⁴⁴ *Ibid* p336

¹⁴⁵ TNA PREM 15/813 "Sterling Agreements" 23 June 1972

¹⁴⁶ TNA PREM 15/813 "Telegram from Soames to FCO" 23 June 1972

Embassy that it was important sterling was re-pegged by the time Britain joined the EEC on 1 January 1973.¹⁴⁷ Floating of sterling also added to the European frustration with the breakdown of the Smithsonian agreement. Between sterling's float and 17 July European central banks took in \$4.9bn as speculators moved against the dollar, highlighting the problem of benign neglect.¹⁴⁸ Therefore Heath's decision undermined any prospect of French cooperation on the sterling balances as part of a European response to the breakdown of Bretton Woods.

The American response was more nuanced. The impact on the dollar was likely to be minimal, as European central banks had a strong interest in not letting the dollar decline and would likely continue to support it until the crisis passed. The failure of the Snake vindicated the American refusal to restore convertibility until a more stable system had been established.¹⁴⁹ In hindsight we can see a certain inevitability to floating, as changes in the global economy, particularly the growth of capital flows and differential rates of inflation raised the cost of commitment to fixed rates. The experience of previous years and a growing academic consensus also testified in floating's favour. However, the way Heath decided to float was handled poorly, given that it upset the French at the same time that a lack of global reform meant Heath now looked upon Europe as a means of support for the sterling balances.

5.8 Post-Bretton Woods Reform – July 1972 – December 1972

The float of sterling marked the definitive breakdown of Smithsonian agreement. The question now turned to what would come next. Britain continued to hope for a general reform to the world's provision of liquidity that would take in sterling's role as an international currency. However, the glut of dollars following the Nixon Shock had undermined concern about a liquidity shortage. As Harold James puts it, "the demand for international reserves was more than filled in a technical sense...but

¹⁴⁷ TNA PREM 15/813 "Letter from Pompidou to Heath" 7 July 1972

¹⁴⁸ Schenk *Decline of Sterling* p327

¹⁴⁹ FRUS 69-76 Vol. 3 "Nixon Memorandum From the President's Assistant for International Economic Affairs (Flanigan) to President Nixon" 23 June 1972

perhaps not a spiritual sense.”¹⁵⁰ Although the dollar’s gold price had been revalued at the Smithsonian, this was somewhat academic given that it remained unconvertible. This gave rise to the unprecedented situation of international payments being conducted based on fiat currencies. This meant continued interest in reform but ultimately little progress as ‘benign neglect’ stoked European resentment before being fatally undermined by the OPEC oil shock which ushered in a new era of international monetary relations.

Britain hoped that the floating of sterling might prompt movement on a grand reform of the system. In a letter written to Heath in the week following sterling’s float, Cromer expressed the belief that the decision might “start to wean the Treasury off the belief that ‘patching up’ Bretton Woods might suffice to meet future needs.” Cromer submitted a paper in which he warned of the danger of a return to the competitive devaluations of the 1930s and claimed the inconvertibility of the dollar since the Nixon Shock marked the beginning of its end as a “serviceable reserve currency.” While this was far off the mark he was more astute in deriding the SDR as an “extraordinarily uncharismatic” and unsuited to the role of the system’s numeraire in that as a “right to contract a loan” it could not compare to “ownership of an asset,” be it gold or dollars. Instead Cromer proposed the creation of a Vehicular Currency Unit [VCU] through which all international payments, both private and public, would be compulsory. The value of this unit could be based either on gold or a basket of commodities or currencies, like the SDR. The main difference was that it would be enshrined under the rules of the system as the only reserve asset for both public and private transactions. No bank would be permitted to maintain an account for a non-resident in local currency, nor would a non-resident’s disposal of assets be bankable in local currency but only in VCUs which would then be converted into the resident’s home currency. Speculative capital flows motivated by interest rate differentials would be eliminated as non-residents would not be able to deposit money in foreign currencies, allowing governments to pursue more expansionary domestic

¹⁵⁰ James *International Monetary Cooperation* pp.229-230

policies, while liquidity growth would depend on the IMF rather than gold or reserve currencies' deficits.¹⁵¹ Although Heath recorded himself in a "good deal of sympathy" with Cromer's ideas, they did not form the basis of the British position. However, Heath agreed that the "mere patching up of Bretton Woods will not be enough" and sought to initiate a lasting change.¹⁵² In his message to Nixon informing the President of the decision to float sterling he argued it was time "to think in terms of much more radical changes than we have as yet envisaged."¹⁵³ Nixon himself was too preoccupied by Watergate to give it much attention, but the reply drafted by Volcker indicated this type of thinking found a reception in the White House:

We should no longer be inhibited by the fear that certain approaches can be unthinkingly damned by some as too "radical" a departure from the past.¹⁵⁴

However, unlike in 1944 at the Bretton Woods conference, America no longer had the power to unilaterally impose its vision of international monetary relations on the rest of world. They faced determined opposition from the French. A meeting between EEC finance ministers and those of joining states held in London in July outlined the main areas of contention. For the French, the main issue was the role of the numeraire in the system. When convertibility was restored, the French demanded to know, into what and with respect to what? The SDR was the natural choice but how would this be constituted in a world awash with liquidity? The French worried that foreign exchange balances would be consolidated in a weak SDR paying a low interest rate and with no intrinsic value, in effect swapping one piece of paper for another. There was deep cynicism that the US would accept the obligations of an SDR standard in which the dollar was convertible and adjusted like any other currency and therefore looked to European monetary union to secure "maximum security of parities with minimum loss of sovereignty." Accordingly, they were supportive of capital controls

¹⁵¹ TNA PREM 15/813 "Letter from Cromer to Heath" 27 June 1972

¹⁵² TNA PREM 15/813 "Armstrong - Principal Private Secretary to PM" 7 July 1972

¹⁵³ FRUS 69-76 Vol.3 "Nixon Memorandum From the President's Assistant for International Economic Affairs (Flanigan) to President Nixon" 23 June 1972

¹⁵⁴ FRUS 69-76 Vol. 3 "Letter From President Nixon to Prime Minister Heath" 10 July 1972; pp.629 – 630; Nixon see Oliver & Hamilton "Downhill from Devaluation" p509

that protected this sovereignty.¹⁵⁵ The sterling balances meant the British were sympathetic to the idea of consolidation through the SDR scheme but American unilateralism meant that Heath placed his hopes in a European initiative and moderated his language accordingly in line with placating French concerns.¹⁵⁶

Within the US Treasury reform proposals were coalescing around 'Plan X' which was due to be unveiled to the world at the IMF annual meeting in the autumn. Under Plan X the SDR would form the numeraire of the system. Exchange rates would be pegged to SDR with margins 3-4% either side but with provision for temporary floating in order to secure adjustment to a new parity. Primary reserves would consist of gold, SDRs and IMF gold tranches while dollars and other foreign exchange reserves would be converted into SDRs during a limited "open season." General convertibility would be in operation, so that a country acquiring foreign exchange reserves would be permitted to present it to the country of origin in return for primary reserves.

The major American innovation was their adoption of objective indicators to facilitate adjustment for both surplus and deficit countries. Although foreign exchange holdings would not be prohibited, once total reserves reached a certain threshold of "normal levels" it would be assumed that adjustment was necessary. At this point convertibility would be suspended, surcharges against exports authorised and pressure to expand aid and liberalise trade and payments applied.¹⁵⁷

Schultz revealed the plan to the world at the IMF meeting. The reaction was generally favourable. A briefing for Kissinger noted a "widespread feeling of relief that the US had resumed position of leadership in monetary affairs." With Schultz talking about dollar convertibility it appeared that more conciliatory relationship with the French was possible.¹⁵⁸ Although holding some doubts about

¹⁵⁵ TNA PREM 15/813 "The EEC, International Monetary Reform and EMU." 18 July 1972

¹⁵⁶ TNA PREM 15/813 "Meeting of Finance Ministers of the EEC and Acceding States" 19 July 1972

¹⁵⁷ FRUS 69-76 Vol. 3 "Paper Prepared in the Department of the Treasury" 31 July 1972

¹⁵⁸ FRUS 69-76 Vol. 3 "Information Memorandum From Robert Hormats of the National Security Council Staff to the President's Assistant for National Security Affairs (Kissinger)" 3 October 1972

the actual operation of reserve indicators, Heath was pleased by the growing consensus in favour of an SDR based scheme.¹⁵⁹

However, this progress was undermined when Volcker argued in a speech in New York that in order to achieve the objective of a 'one world' system laid out by Schultz at the IMF, progress was needed on removing trade and investment restrictions. In particular Volcker argued that reform to trade and monetary arrangements should proceed in tandem so that incentives involving trade liberalisation could be built into the adjustment process.¹⁶⁰ The renewed focus on the indivisibility of the American proposals disappointed the British Treasury who felt it conflicted with recent affirmations that the American position was a flexible one.¹⁶¹ This confusion over American priorities and execution meant that progress on global international reform made little progress throughout 1972 and was soon overtaken by another exchange crisis, this time concerning the dollar. Once again, despite innate sympathy for the American position, Britain found itself alongside the Europeans but with policies unaligned.

5.9: A European Solution? – January 1973 – September 1973

International reform discussions were derailed by series of dollar crises at the beginning of 1973 that demonstrated the limits of benign neglect, but also the scope of American commitment to reform beyond securing greater flexibility in adjustment. The Americans were forced to reappraise their policy for the dollar but were still unable to enforce their vision of a reformed monetary system against European resistance. Instead a compromise involving a managed float of the dollar restored competitiveness to the American currency while also fatally undermining the desire to proceed with general liquidity reform.

¹⁵⁹ TNA PREM 15/1457 "Letter from Heath To Japanese PM" 10 October 1972

¹⁶⁰ TNA T354/147 "Speech by Volcker international Finance and Monetary Reform Sessions of the National Foreign Trade Convention" at Waldorf-Astoria Hotel at New York 13 November" 14 November 1972; *The Times* 14 November 1972

¹⁶¹ TNA T354/147 "Letter from Allen to Cromer" 20 November 1972

The year began with what Burns described as a “jittery atmosphere” prevailing in the market in response to the Italian decision to establish a dual-exchange system and the floating of the Swiss franc at the end of January. More fundamental problems, according to Burns, lay in uncertainty over the future prospect of the monetary system, given the continued American deficit and the lack of progress over meaningful reform. The danger was that rather than leading to a liberalised multilateral system of trade and payments, American benign neglect might instead prompt a return to the nationalism and bilateralism of the pre-war period.¹⁶²

Burns proposed Nixon pressure Heath to take the initiative in Europe and speed up the progress of reform. Opposing this view was Schultz who denied the need for any precipitate action and was concerned that a short-term fix would prevent more meaningful reform further down the line.¹⁶³ Since 22 January, \$4.3bn had flowed out of dollars, with \$2.6bn going into deutschmarks. When asked what they should do about it, Schultz shrugged that the speculation was “based on reality.” With a \$6bn deficit projected for the year, Schultz argued that the Smithsonian agreement had failed to offer the correction required for US competitiveness, noting that some countries – particularly Britain – had restored their competitiveness by exchange rate changes since then. Schultz argued for a US devaluation of 6.5% and a Japanese revaluation of similar magnitude while inducing the Europeans to hold the line and not follow the dollar down.¹⁶⁴

Within the administration Schultz continued to endorse floating as a means of adjustment, noting the British experience indicated it was more successful than successive devaluations by providing some form of insulation against speculative movements. However, Nixon was resistant to applying this lesson to the dollar, worrying that while it was applicable for sterling, for America it would be too much of a “to hell with the rest of the world” policy.¹⁶⁵ Burns eagerly agreed. Explicitly floating

¹⁶² Foreign Relations of the United States 1969- 1976 Vol.31 Foreign Economic Policy 1973-1976 “Letter From the Chairman of the Federal Reserve System Board of Governors (Burns) to President Nixon” 1 February 1973

¹⁶³ FRUS 69-76 Vol. 31 “editorial note” 01 January 1973

¹⁶⁴ FRUS 69-76 Vol. 31 Conversation Among President Nixon, Secretary of the Treasury Shultz, and the Chairman of the Federal Reserve System Board of Governors (Burns) 06 February 1973

¹⁶⁵ *Ibid.*

the dollar would be considered an act of “economic belligerency.”¹⁶⁶ Instead Paul Volcker was dispatched on a tour of Japan and the European capitals to thrash out a fresh realignment of parities.¹⁶⁷

The dollar crisis compounded the difficult position Heath found himself in regarding his European partners in 1973. The UK had formally become a member of the EEC on New Year’s Day, at which point the French expected sterling to re-join the Snake. However, both the Treasury and Bank of England expressed doubts about maintaining fixed rates in Europe at the current time, given the differing success in controlling inflation and the time needed to align economic performance.

Although loath to disappoint the French by floating after 1 January, it was agreed it would be worse to re-fix only to be pushed off parity shortly after.¹⁶⁸ Concerned about the prospects of talks with the CBI and TUC as part of the government’s anti-inflation policy, Heath wrote to Pompidou committing himself to fixed rates in principle but proposing instead to do so by 1 April. At this point a European Monetary Co-Operation Fund [EMCF] was due to be set up that Heath believed would be able to support sterling and prevent it dropping out again.¹⁶⁹ Heath was reluctant to engage in fresh commitment for sterling without a corresponding degree of support, placing him in direct opposition to the French who were adamant that support would only be forthcoming once sterling had re-engaged with the Snake system of parities. In doing so, Heath traded flexibility for support.

Heath’s reluctance to commit to fresh external obligations was down to the unstable situation in the domestic economy. O’Brien was warning that prospects for domestic growth were dependent on success in controlling inflation and improving investment. With monetary policy having tightened since the beginning of the year, O’Brien felt that fiscal policy must now be brought into line, with the £4bn Public Sector Borrowing Requirement indicating an “an excessively expansionary stance” that

¹⁶⁶ *Ibid.*

¹⁶⁷ Allen Matusow *Nixon’s Economy* p235

¹⁶⁸ TNA PREM 15/1457 "Re-fixing the Sterling Exchange Rate" 6 October 1972

¹⁶⁹ TNA PREM 15/1457 "Letter from Heath to Pompidou" 13 December 1972

would further exacerbate inflation.¹⁷⁰ The rise in the value of sterling as capital flowed out of the dollar and into European currencies raised fears in Britain that there would be renewed European pressure to fix the currency within the Snake.¹⁷¹ However Heath also spied an opportunity in the dollar crisis, believing the time was right for decisive European action on monetary integration including British involvement in return for European commitment on the sterling balances.

Speaking with Brandt on the 9 February, Heath sympathised with the plight of the Germans who were taking in unprecedented amounts of dollars because of the crisis and agreed to a meeting of European finance ministers to be held that weekend in Paris.¹⁷² Conferring with his Treasury advisers, Heath was told that outcome of the crisis likely involved three possibilities: a US devaluation, a collective European float or universal adoption of two tier exchange markets.¹⁷³

The German position had by this time become critical. In a defensive letter to Nixon, Brandt argued that his government had fulfilled its obligations towards the Smithsonian in both letter and spirit. The two previous revaluations of the Deutschmark had demonstrated German commitment to international solidarity but felt that a further revaluation would be inappropriate given domestic circumstances and called on the Americans to do “everything in their power” to support the dollar.¹⁷⁴ In reply Nixon stated that the US had in fact undertaken intervention in support of the dollar, despite making no such commitment to do so at the Smithsonian. He agreed that the time was right for urgent action and referred to his dispatch of Paul Volcker to facilitate multilateral agreement.¹⁷⁵

¹⁷⁰ TNA PREM 15/1458 "Letter from Governor to Chancellor" 9 February 1972

¹⁷¹ Schenk *Decline of Sterling* p341

¹⁷² TNA PREM 15/1458 "Telephone Conversation Between the PM and Herr Brandt at 11.40AM" 9 February 1972

¹⁷³ Heath was intrigued by this last option but was cautioned it would be extremely difficult to keep official and commercial markets separate, with a discounted commercial sterling likely to drag the official rate down, TNA PREM 15/1458 "Note for the Record" 09 February 1973

¹⁷⁴ FRUS 69-76 Vol. 31 "Letter From the West German Chargé d'Affaires Ad Interim in the United States (Noebel) to President Nixon" 09 February 1973

¹⁷⁵ FRUS 69-76 Vol. 31 "Telegram From the Department of State to the Embassy in the Federal Republic of Germany" 10 February 1973

Speaking to Heath the following day, Brandt warned that if the Germans were forced into unilateral action by lack of American support it would mean the postponement of European plans for economic and monetary union for some time.¹⁷⁶ Barber reported that his opposite number Helmut Schmidt had said a two-tier market was not possible and the DM would have to float if no other solution was forthcoming. Discussion at the European meeting had turned to the chances of a joint European float. The French were in favour to which Barber had reiterated the British desire not to re-fix prematurely. Schmidt had then spoken of the support the Germans could provide towards maintaining a common float. After Barber had reported this discussion back to Heath, the Prime Minister suggested outflanking the Community float with a more ambitious solution involving complete monetary union and joint pooling of reserves.¹⁷⁷

Meanwhile Paul Volcker had arrived in Germany from Japan and outlined three alternatives to Brandt: a joint float, no action, or the US favoured proposal of devaluation. Under the third proposal, Volcker emphasised the German responsibility to hold their current rate and looked for them to influence Europe on capital controls and gold.¹⁷⁸ The next day, on the 11th, Volcker report back to Washington after a “long, rough and tough” session with Giscard d’Estaing in which he had outlined the same choices. Giscard accused the US of not doing enough to maintain the existing system of parities and talked about the European joint float which he explained as a European effort to construct its own monetary system.¹⁷⁹ Volcker moved onto London, where Heath – who had been forewarned about the 3 options by Brandt – had already decided that a US devaluation of 10% and a Japanese float were the most agreeable outcomes from the British point of view.¹⁸⁰

¹⁷⁶ TNA PREM 15/1458 "Record of a Telephone Conversation Between Heath and Brandt at 9:30pm" 10 February 1973

¹⁷⁷ TNA PREM 15/1458 "Note for the Record" 10 February 1973

¹⁷⁸ FRUS 69-76 Vol. 31 "Notes of a Telephone Conversation Between Secretary of the Treasury Shultz and the Under Secretary of the Treasury for Monetary Affairs (Volcker) 7.30am" 11 February 1973

¹⁷⁹ FRUS 69-76 Vol. 31 "Notes of a Telephone Conversation Among Secretary of the Treasury Shultz, the Deputy Under Secretary of the Treasury for Monetary Affairs (Bennett), and the Under Secretary of the Treasury for Monetary Affairs (Volcker)" 11 February 1973

¹⁸⁰ *Ibid*; PREM 15/1458 "Note for the Record" 10 February 1973

Barber called Schultz at 3pm on the 11th to inform him that Volcker's 3rd option was agreeable, while sterling would continue to float. On the evening of the 12th Schultz announced the devaluation of the US dollar.¹⁸¹ Speaking to the press the next day, Giscard stated that the main French concern was to find a European solution. The calm restored by the dollar's devaluation was short lived and by the end of the month speculation had built to the extent that Nixon appeared at a press conference to announce the US would "survive" the international attack on the dollar made by speculators and stated categorically that there would be no further devaluation.¹⁸²

The renewed speculation and American reluctance to move again so shortly after the previous devaluation meant the initiative moved once more into the European court. For the British, this meant another opportunity to press for consolidation of the sterling balances. Meeting with Brandt in Bonn on 1 March, Heath argued for a substantial acceleration in the timings towards monetary union laid out in the Werner report. According to Heath, the current crisis meant that Europe needed to contain the dollar flow and establish a European solution, involving reserve pooling and economic and monetary union.¹⁸³

Outlining the German position, Pohl of the Bundesbank remarked that while floating of DM was attractive from a purely national viewpoint, it would come as great shock to the EEC and end the current progress towards European monetary union. Prior to Volcker's mission the Germans had been in favour of a joint float but the recent dollar devaluation had prevented this. Now with the Americans ruling out any further action on the dollar, it seemed an idea whose time had come. From a technical standpoint, as an initial step it would only require non-intervention with regards to dollars, while intervening within the EEC to maintain fixed parities. This however would then be

¹⁸¹ FRUS 69-76 Vol. 31 Editorial Note 10 February 1973

¹⁸² *Ibid*

¹⁸³ TNA PREM 15/1459 "Record of a Conversation Between the Prime Minister and the Chancellor of the Federal Republic of Germany, 10.55pm" 10 February 1973

followed by pooling of national reserves, a European central bank and possibly even a European treasury.¹⁸⁴

To Brandt, the main question was how the Community would respond. Following the disastrous 1968 Bonn conference 1968, as well as criticism of his *Ostpolitik* policy of engaging the eastern bloc, there was concern among other western countries about increasing German autonomy. Brandt therefore wished to respond in conjunction with Europe.¹⁸⁵ This could take place without sterling or with special measures in place to support it. Based on O'Brien's conversations with Emminger of the Bundesbank in Basle three weeks earlier, Heath was not convinced the EEC had the machinery to make a joint float work with sterling included.¹⁸⁶ However, Brandt recognised these concerns and expressed willingness to make the required funds available without interest and obligation to repay in order to facilitate British participation. Accordingly, the two leaders agreed to use the present crisis as a "springboard" for a major advance towards economic and monetary union.¹⁸⁷

The idea that the crisis might provide some form of final resolution of the overhang, and hence remove a major source of instability for sterling, was naturally one that Heath jumped at. As Heath noted back in London, the Germans had made it clear they were willing to pay a high price for a Community solution. Reporting on his own discussions, Barber claimed Schmidt had previously said the British could count on as much support as they liked in return for British participation in the joint float.¹⁸⁸ The Anglo-German initiative even caused a minor spat with Washington, after Brandt sent what was described by Burns as a "bombastically arrogant" message to Nixon in which he claimed

¹⁸⁴ *Ibid*

¹⁸⁵ Hubert Zimmerman "The Fall of Bretton Woods and the Emergence of the Werner Plan" in Bo Strath and Lars Magnusson [eds.] *From the Werner Plan to the EMU: In Search of a Political Economy in Europe* (Brussels: European Interuniversity Press, 2002) p69

¹⁸⁶ TNA PREM 15/1459 "Record of a Conversation Between Prime Minister and the Chancellor 5.35pm" 01 March 1973

¹⁸⁷ TNA PREM 15/1459 "Tel no 293" 2 March 1973

¹⁸⁸ PREM 15/1459 "Note of a Meeting held at 10 Downing Street at 10.30pm" 02 March 1973

that any solution must further European integration and would be decided in the EEC Finance ministers meeting.¹⁸⁹

The solution did not however materialise as it was unacceptable to the French, causing the Germans to row back from their previous commitment to the British. For the French, the point of European monetary union was to reassert national sovereignty against international capital markets. However, this did not extend to pooling sovereignty in monetary affairs if that meant assuming the liabilities of sterling.¹⁹⁰ At the meeting of finance ministers, Barber laid out his conditions for British participation in the joint float: unconditional mutual financial support without limits and without specific obligations. Robert Solomon, a US participant in the reform debates, did not think it was a serious demand, later commenting “to say it lacked subtlety is to treat it kindly.”¹⁹¹ However, behind the scenes Heath continued to push Brandt on his previous commitment to support sterling as a part of a mutual European response to the dollar crisis. In a letter to the German chancellor, Heath noted:

[I was] greatly heartened when you indicated to me that you were thinking on these lines, because it seemed to me that we might have within the Community’s grasp a possibility that would constitute, not only a significant new development in international defences against short term capital flows, but also a major step forward in the progress of cooperation within the enlarged community...I should be very interested to know whether your thinking continues to correspond with mine as closely as it clearly did when we met.¹⁹²

In his reply Brandt claimed his opinion was unchanged but found the French to be more reluctant than he had anticipated.¹⁹³ He also felt that support without conditions would speed up inflationary process by financing unsustainable deficits and, on the question of sterling balances, provoke movements out of sterling.¹⁹⁴ Meeting with a French counterpart, Tomkins of the Treasury was told

¹⁸⁹ FRUS 69-76 Vol. 31 “Message From West German Chancellor Brandt to President Nixon” 2 March 1973

¹⁹⁰ Zimmerman “The Fall of Bretton Woods and the Emergence of the Werner Plan” pp. 71-72

¹⁹¹ Solomon *The International Monetary System 1945 - 1976* p232

¹⁹² TNA PREM 15/1459 “Telegram from Heath to Brandt” 6 March 1973

¹⁹³ TNA PREM 15/1459 “Tel no 318” 7 March 1973

¹⁹⁴ TNA PREM 15/1459 “Letter from Brandt to Heath” 8 March 1973

that no-one in the EEC accepted Barber's conditions and in the view of the French there was no possibility of sterling joining the joint float on this basis.¹⁹⁵

At a meeting of the EEC Monetary Committee on 7 March a majority was in favour of a joint float with parities fixed within 2.25% bands. The Committee recognised that not all countries would be able to participate right away but decided support facilities "could in no case serve to finance deficits" which should be dealt with by policies aimed at re-establishing internal equilibrium.¹⁹⁶

However outside the committee, Barber and O'Brien were warned by Le Clerq, the President of the EEC Council, that if Britain did not join the joint float it could prove a mortal blow to the community. Noting the British proposals had found little support, Le Clerq asked whether they were unalterable. Barber denied the proposals had represented a negotiating position from which to haggle but rather were essential conditions for sterling to participate in a joint float without being forced off parity soon after fixing it.¹⁹⁷

The hardening of European opinion prompted Heath to reconsider, warning Barber that the British objective was to find grounds on which Britain could participate in the float or at least to avoid the blame for not participating. As Barber's conditions had been received on a "take it or leave it" basis, Heath now urged consideration as to whether any concessions could in fact be made for British participation.¹⁹⁸ In a telegram from the Foreign Office to all EEC posts, British diplomats were briefed that Barber's conditions were not a debating point or attempts to find a solution to only Britain's problems but rather to take a "very big stride towards the goal of monetary union."¹⁹⁹

Discussing the situation prior to a meeting of EEC finance ministers with Barber on 11 March, Schmidt outlined the likely outcome as a joint float between Germany, France, Benelux and Denmark. At the meeting itself, the fixing of parities with a 2.25% margin and establishment of a

¹⁹⁵ TNA PREM 15/1459 "Tel No 369" 7 March

¹⁹⁶ TNA PREM 15/1459 "Tel No 1202" 7 March 1973

¹⁹⁷ TNA PREM 15/1459 "Tel No 373" 8 March 1973

¹⁹⁸ TNA PREM 15/1459 "Letter from Robert Armstrong to Barber" 10 March 1973

¹⁹⁹ TNA PREM 15/1459 "Telegram from FCO to all EEC posts" 10 March 1973

reserve currency fund by 1 July was used as a basis for discussion. Barber defended his proposals as acting within the spirit of the community and reiterated his position that it would be impractical for sterling to fix now but that Britain would do so when the time was right.²⁰⁰ The decision was taken for a joint float by Germany, France, the Benelux countries and Denmark as well as non-members Norway and Sweden. Lacking a system of support to maintain cohesion within the joint float it did survive the impact of the OPEC crisis.²⁰¹ Notably however, another nonparticipating country Italy, was the other European country to request IMF support following the oil crisis, suggesting the discipline of maintaining a currency peg moderated the expansion of external deficits.

Assessing the outcome, Heath conceded it was the best that could have been expected given the nature of French opposition to British proposals. However, British credibility and standing within the Community had been damaged. Heath believed the Bank of England and Treasury did not understand the implications of this outcome and while he accepted no one wanted to see a repeat of the years between 1964 and 1967, “we did not join the Community to behave like little Englanders.” Heath’s major concern was that being detached from a key European policy would result in a lack of British influence and a lack of opportunity to benefit from the advantageous terms the Germans were prepared to offer.²⁰²

As Dyson and Featherstone note in their history on European monetary union, “Heath’s European ambitions were ahead of Britain’s ability to deliver.”²⁰³ According to Harold James, the British experience in the Snake demonstrated the limits of European cooperation in monetary relations: there was no financial assistance for sterling, nor did European central banks intervene to support the currency beyond 4pm Central European Time, leading to shifts in value of sterling while the UK and US markets were still open.²⁰⁴ However this also reflected the reluctance of Heath to assume

²⁰⁰ TNA PREM 15/1459 “Tel no 1320” 11 March 1973

²⁰¹ Erik Hoffmeyer *The International Monetary System: An Essay in Interpretation* (Amsterdam: Elsevier, 1992) p116

²⁰² TNA PREM 15/1459 “Letter from Heath to Barber” 12 March 1973

²⁰³ Dyson and Featherstone *The Road to Maastricht* p538

²⁰⁴ James *Making the European Monetary Union* p105

fresh commitments for sterling to replace those of Bretton Woods. This political decision removed the constraint of a pegged exchange rate but at the cost of isolating sterling from a potential source of support.

The joint float did not take pressure off the dollar for long. Worsening inflation and reports that Nixon would resign in response to the developing Watergate scandal led to a free fall in the dollar.²⁰⁵ At the end of June, Cromer warned Heath that a collapse of the dollar could take on its own momentum with direct consequences for the British economy.²⁰⁶ Consulting with Pohl of the Bundesbank, Heath was told that while the American balance of payments was improving, nervousness on Wall Street and repercussions over Watergate were harming the dollar.²⁰⁷ As Cromer had warned, the dollar's fall had repercussions for the pound which was 16% down on its Smithsonian parity, undermining the government's anti-inflation policy as higher import prices fed through into the economy.²⁰⁸ Heath was reluctant to raise interest rates for its effect on domestic growth but authorised a rise in the Minimum Lending Rate [MLR] by 1 ppt. on the 25th July.²⁰⁹ In a letter to Brandt at the end of the month, Heath blamed "exceptionally high interest rates" which prevailed in Germany for drawing funds away from Britain. As a result, the MLR rose a further 2 ppt. to 11.5% which in Heath's view was intolerable given the level of unemployment and slackening of consumer demand.²¹⁰

The decline of the dollar caused consternation in Europe for its effect on the pegged parities within the joint float.²¹¹ The Europeans wanted the Americans to intervene in support of the dollar, helping to make a commitment to stability in foreign exchange. The new Governor of the Bank of England Gordon Richardson (who had taken over from O'Brien in July 1973) reported back from a "long and

²⁰⁵ Matusow *Nixon's Economy* p237

²⁰⁶ TNA PREM 15/1461 "Letter from Cromer to Heath" 26 June 1973

²⁰⁷ TNA PREM 15/1461 "Note for the Record, Foreign Exchange Market and exchange Rates" 05 July 1973

²⁰⁸ TNA PREM 15/1461 "Foreign Exchange Markets and Exchange Rates" 06 July 1973

²⁰⁹ TNA PREM 15/1461 "Foreign Exchange Markets" 25 July 1973

²¹⁰ TNA PREM 15/1461 "Tel no 480" 31 July 1973

²¹¹ FRUS 69-76 Vol. 31 "Memorandum of Conversation" 31 May 1973

barbarous" discussion in Basle on the possibility of American intervention in which the President of the BIS, Dr Zijlstra indicated he thought they were on the edge of a major exchange crisis. The US representative expressed agreement on the principle of intervention, using European swap networks, but after he had spoken Volcker on an open line it became clear that the Americans were reluctant to commit themselves.²¹²

Within Washington, the State department was in favour of intervention, arguing that until the US demonstrated a willingness to support the dollar, speculators had a one-way bet. It would also help Europe alleviate what was becoming a major problem, strengthening the hand of those in Europe who opposed unilateral and restrictive practices, while building support for the more flexible system the Americans wanted.²¹³ Burns was in favour, but Schultz only agreed to minor intervention. As it turned out this was enough. After announcing an increase in its swap credit line on 10 July, the dollar stabilised before rising in August in response to improving trade balance and tighter interest rates in the US.²¹⁴

Reform discussions continued following stabilisation of the dollar, but Britain continued to struggle to find partners for a new international form of liquidity into which the sterling balances could be consolidated. As before, Britain's influence was constrained by needing to align with European countries which were deeply suspicious of what they perceived as American proposals for liquidity reform that would let deficit countries off the hook. In a letter to Pompidou, Heath agreed that the recent crisis had demonstrated the danger of large flows of unrestricted capital, destabilising currencies and enforcing inappropriate domestic policies. However, Pompidou was not impressed by Heath's argument that the fundamental cause was the lack of a credible international reserve credit. Pompidou envisaged convertibility would be restored in a two-stage process whereby first the dollar would become convertible before general convertibility of all currencies into a new reserve asset,

²¹² TNA PREM 15/1461 "Foreign Exchange Markets" 09 July 1973

²¹³ FRUS 69-76 Vol. 31 "Memorandum From Charles Cooper of the National Security Council Staff to the President's Assistant for National Security Affairs (Kissinger)" 11 July 1973

²¹⁴ Matusow *Nixon's Economy* p237

abolishing the role of reserve currencies. However, he was suspicious of the SDR, believing it to be a paper asset with no intrinsic value, at the disposal of an institution based in the US and dominated by the US Treasury. It would establish a system based on permanent inflation due to excessive US credit growth.²¹⁵

Pompidou was also disappointed by the continued float of sterling, having been led to believe it would be re-fixed on 1 April. Now he realised this would not be the case. In an upset for Heath's plans for European monetary union he warned the British Ambassador Soames there would be no EMCF if sterling floated apart from the European currencies. This was the reversed order of how Heath envisaged proceeding, with sterling able to re-fix once the appropriate institutional machinery was in place to support it.²¹⁶ Heath's domestic expansion had undermined any chances of French support for liquidity reform, either at a European or global level, by prioritising the domestic growth over stability of the currency.

Meanwhile with the dollar stabilised at a newly competitive rate, American support for such reform was also lower. Speaking with Volcker in June, Rawlinson conveyed Barber's wish to agree the shape of reform by the IMF Annual Meeting in September, suggesting that now the US had gained general agreement on adjustment they might cooperate on convertibility and consolidation. Volcker however saw no prospect that Congress would agree to consolidation that meant paying more than on the existing holdings of dollars, which meant European demands for an SDR carrying a high interest rate would go nowhere.²¹⁷

Accordingly, expectations were low for the 1973 IMF General Meeting, held in Nairobi. No major initiative was made on the three outstanding issues of reform: gold, the dollar overhang or convertibility. Testifying before Congress, Volcker argued the major developments at Nairobi had been agreement on need to establish clear symmetrical disciplines operating on both surplus and

²¹⁵ TNA PREM 15/1460 "Note for the Record" 22 May 1973

²¹⁶ TNA PREM 15/1460 "Tel No 1513" 20 March 1973

²¹⁷ T354/385 "International Monetary Reform: Conversation with Mr Volcker" 14 June 1973

deficit countries. The detail that needed to be clarified was how reserve indicators, consultations and disciplines would work in practices in effecting adjustment.²¹⁸ However any movement towards a grand reform of Bretton Woods was about to be undermined by the OPEC oil shock. This was to fundamentally end any prospect of European monetary union or a wider reform to liquidity.

5.10: Conclusion

The period of Edward Heath's premiership between 1970 and the end of 1973 witnesses a dramatic change in the international monetary relations. The Bretton Woods system fell apart as a result of American unilateralism and was gradually replaced with a fiat floating standard. These changes resulted in a reappraisal of sterling's international obligations and an attempt by Heath to renegotiate the external constraint these commitments implied.

Heath took advantage of greater flexibility in adjustment to remove external restrictions on his domestic expansion, floating sterling rather than assuming debt or spending Britain's considerable reserves to defend the rate. Confidence in sterling was maintained through continuation of the 1968 Basle guarantees. Collectively these choices eased the external constraint in the short term, allowing expansion to proceed and with less regard to current account deficits than had occurred under Bretton Woods.

Heath was unable however to secure any long-term reform of sterling's overhang, as interest in liquidity reform evaporated in the face of an increasingly conflictual American approach to economic diplomacy, as well as the expansion of liquidity as a result of benign neglect. Heath's priorities were made clear during negotiations over European monetary union. He traded flexibility for support, refusing to accept any fresh commitments for sterling that might act as a new constraint on domestic growth. This was the apparent lesson of the previous Labour government's struggle to defend the rate.

²¹⁸ TNA T312/3003 "Current Status of International Monetary Reform" 13 November 1973

This renegotiation of the external constraint therefore removed any discipline on domestic expansion resulting in a high external deficit just as the global economy was about to suffer another shock in the form of the OPEC crisis. Although European plans for monetary union were immature and would not survive this next crisis, they did act as a source of discipline on current account expansion, leaving participants less exposed when the OPEC crisis decisively turned the terms of trade against developed economies. Heath's refusal to participate demonstrated that despite his pro-European inclinations, he prioritised his domestic objective of growth. In going it alone, he secured flexibility and temporary confidence in sterling at the cost of isolating Britain from sources of support.

Chapter 6

What Crisis?

6.1: Introduction

The final resolution of the sterling overhang took place against the backdrop of seismic change in the global economy. The OPEC oil shock in December 1973 proved to be the final nail in the Bretton Woods coffin, while the resulting stagflation marked the end of the long post-war boom. Economic policy across the industrialised world began to focus on controlling inflation rather than maintaining output. Monetarism gained ground at the expense of Keynesianism by offering policy prescriptions tailored to these new concerns.¹ The differing levels of success across countries in controlling inflation meant pegged exchange rates became untenable. In response, the long-term process of international monetary reform culminated in formalising floating rates and demonetising gold.² For the Labour government that had replaced Heath's Conservatives in 1974, adapting to these new conditions proved a challenge. Struggling on a wafer-thin majority and attempting to placate an increasingly militant trade union movement, Labour's initial response to the OPEC crisis was to maintain demand and finance the external deficit inherited from Heath by building up the sterling balances among the newly enriched Middle East holders.³ A change in market sentiment from July 1975 meant despite the subsequent shift in policy on government spending and control of the money supply, recourse to the IMF was required in 1976 before market confidence was restored.⁴

¹ Peter A. Hall "The Movement from Keynesianism to monetarism: Institutional Analysis and British Economic Policy in the 1970s" in S. Steinmo, K. Thelen, & F. Longstreth (Eds.), *Structuring Politics: Historical Institutionalism in Comparative Analysis* (Cambridge: Cambridge University Press, 1992) pp 90 -92

² Eichengreen *Globalizing Capital* p137

³ Robert Skidelsky *Britain Since 1900 A Success Story?* (London: Vintage Books, 2014) pp.314-316

⁴ *Wass Decline to Fall* pp. 44-45

The IMF crisis has generated voluminous historical analysis seeking to understand events of 1974-76. The historical record has sought to understand Labour's motivations for seeking a settlement with the Fund and what consequences this had for Britain's system of economic management. Debate has largely turned on whether policy change was imposed on Britain from outside and the extent to which this change in policy was ideologically informed by the monetarist and neo-liberal ideas then in the ascendancy and represented in the post-war consensus of policy.

For Kathleen Burk & Alec Cairncross, the crisis witnessed the IMF's programme of conditionality being leveraged by the US Treasury in order to effect policy change on Britain. Concerned about the left-wing direction of Labour and the danger that a collapse in sterling might provoke a siege economy (and subsequent withdrawal from NATO and the EEC), the Americans looked to use IMF negotiations to force domestic retrenchment on Labour, tying access to the Fund's standby facilities to strict conditions on government spending and growth of the money supply. Despite Prime Minister Jim Callaghan's efforts to escape IMF conditionality through his personal lobbying of President Ford and West German Chancellor Helmut Schmidt, in the end Labour was forced to accept the shift in policy mandated by the Fund.⁵

Mark Harmon examines the extent to which the imperative to secure agreement with the fund resulted in the Fund's conditionality playing a role in forcing policy change on Britain. Drawing on regime theory, Harmon argues that Labour's space for policy choice was effectively constrained by the structural power of international cooperation, which he views rather as "relations of coercion," with which left-of-centre governments much seek accommodation to sustain themselves in power. Economic policy became decided by 'external actors' – market confidence, the conditions attached to the IMF loan and, ultimately, the attitude of the US Treasury. Together these set the parameters

⁵ Burk & Cairncross *Goodbye Great Britain* p56

for economic policy. While this succeeded in restoring confidence in sterling, it was at the cost of Labour's domestic support, resulting in a loss of power in 1979 following the Winter of Discontent.⁶

Peter Hall views the increasing external pressure of market sentiment impelling a change in government policy. Interested in the role of economic ideas in policy making, he construes the period of 1975-79 constituting a shift towards monetarism by the Labour government in order to placate opinion in the markets for government debt and foreign exchange which was itself increasingly interested in these ideas. In doing so, economic policy underwent a 'paradigm shift' – a discontinuous break in which the overarching goals of policy changed as well as the instruments used to achieve them. This change was determined by political criteria, reflecting a process of state-social learning in which demand for monetarist policy became an "object of electoral competition", championed by the financial press, opposition party and eventually office of the Prime Minister, who overruled the Treasury.⁷ This view has been revised somewhat by Kevin Hickson's more detailed investigation of the influence of economic thought on the politics of the Labour government. Hickson concludes that rather than a wholesale adoption of monetarist ideas, Labour instead accepted some associated ideas of economic liberalism, including crowding-out and supply side theories.⁸

The extent to which IMF negotiations themselves proved the catalyst for policy change within the Labour government has been revised by the historical record. In an influential 1992 article, Steve Ludlam challenged the 'four myths' of 1976, namely that the Fund forced Labour to reduce government spending, introduce cash limits and monetary targets while abandoning the pursuit of full employment through demand management. Instead, Ludlam notes that important policy decisions had already been taken in 1975, prior to any negotiation with the Fund, while the 1976

⁶ Harmon, *The British Labour Government* p. ix, 4

⁷ Peter Hall, "Policy Paradigms, Social Learning, and the State" p. 286

⁸ Hickson, *The IMF Crisis of 1976*, p214

agreement merely “codified a change in political course already well underway.”⁹ This view has been confirmed by Douglas Wass, Permanent Secretary to the Treasury throughout the crisis who subsequently has written an extensive administrative history of the period. Wass argues the descent to the IMF negotiations were the product of failure of economic policy making by the Labour leadership and Treasury from 1974.¹⁰

Revisionist understanding of the domestic implications of the crisis has been taken furthest by Chris Rogers. Rather than IMF conditionality being imposed on domestic policy, Rogers argues that it was instead used by the Treasury to depoliticise the consequences of their preferred economic policies. The prospect of an external financing gap and the downward spiral of the pound from 1975 onwards (which Rogers labels “two non-crises” – based on projections of dubious validity in the case of the former, while securing a competitive devaluation was a Treasury objective), were positioned as implying there was no alternative to recourse to the IMF. In doing so, Callaghan was able to face down calls from the left wing of the party for a radical Alternative Economic Strategy [AES], since adopting protectionist measures such as import controls would be incompatible with borrowing from the Fund. According to Rogers:

currency instability and IMF conditionality provided strong and credible justifications for the implementation of policies....and acted as a buttress between the government and the consequences of its policies.¹¹

These analyses share a common understanding of the scope of the crisis. Sterling was unstable due to the current account deficit inherited from Heath’s government, exacerbated by the impact of the OPEC shock. Similarly, following agreement with the Fund, either due to its impact on policy or approval of existing policies, sterling stabilised into 1977. The most remarkable feature of this

⁹ Steve Ludlam “The Gnomes of Washington: Four Myths of the 1976 IMF Crisis,” *Political Studies* (1992) Vol. 40 (4) p727

¹⁰ Wass, *Decline to Fall*, p. xiii

¹¹ Chris Rogers, “The Politics of Economic Policy-Making under Harold Wilson and James Callaghan and the 1976 IMF crisis,” (Unpublished PhD Thesis, University of Warwick, 2009), p21, 169, 204

process was the shift in economic policy, which foreshadowed the much more enthusiastic embrace of neo-liberal policies by the Thatcher government from 1979 onwards.¹²

Accordingly, the subsequent Third Group Arrangement negotiated with the BIS at the beginning of 1977 (distinguished internally as the 'facility' in contrast to the IMF 'standby'), in which a credit line was extended to manage sterling diversification, has received less detailed investigation. Burk & Cairncross consider that while the IMF deal "fulfilled expectations," the BIS deal did not, as sterling holdings were not run down any further in response to sterling's growing attractiveness following conclusion of the IMF negotiations and the prospects of the North Sea oil.¹³ Harmon also believes the deal disappointed expectations, noting it was not announced simultaneously with the IMF bailout as Callaghan had hoped and served rather to re-enforce IMF conditionality, given the Managing Director's role in overseeing compliance.¹⁴ For Dell, Callaghan overestimated the importance of the sterling balances in the crisis, arguing the BIS deal was unnecessary once the correct economic policies were being applied (a restatement of the American position).¹⁵ Hickson considers it only partially successful since it did not cover private balances as well as public ones, failing therefore to reduce the sterling balances significantly.¹⁶ Rogers views the threat posed the danger of sterling balance diversification supporting the Treasury's arguments for reduced expenditure and direct wage controls, but considers them less important once it was clear no additional support would be forthcoming prior to agreement with the Fund.¹⁷

Catherine Schenk's review of sterling's retreat from its international role has accorded the 1977 Basle facility more importance than traditional accounts. Viewing the IMF standby as "merely a consolidation" of previous support packages arranged over the previous year, the 1977 deal marked

¹² *Ibid*, pp. 1-2; Hall, "Policy Paradigms, Social Learning, and the State," p286, Burk & Cairncross, *Goodbye Great Britain*, p213

¹³ Burk & Cairncross *Goodbye Great Britain* pp. 111, 126

¹⁴ Harmon *The British Labour Government and the 1976 IMF Crisis* p227

¹⁵ Dell *The Chancellors* pp. 437 - 438

¹⁶ Hickson *The IMF Crisis of 1976* p153

¹⁷ Rogers "The Politics of Economic Policy-Making" pp. 162, 258, 293,

“further fundamental change in Britain’s external economic policy and had a long term impact on the role of sterling as an international currency.”¹⁸ Like its 1968 predecessor, the very existence of the deal fulfilled its objectives and did not need to be drawn upon.¹⁹ As sterling recovered from the beginning of 1977 and North Sea oil came on stream, the build-up of sterling assets finally ended the sterling overhang. As such the rescue package could be deemed successful.²⁰ This was the conclusion of the multilateral process aimed at retiring sterling’s reserve role that had been ongoing since the 1950s which had been achieved via multilateral negotiation, rather than through market forces.²¹

This thesis refines Schenk’s interpretation by arguing the British response to the 1976 IMF crisis marked the first-time official commitment to ending sterling’s reserve role was backed by both firm policy action and the international support required to do so. The crisis itself is positioned not as the impact of market forces on domestic autonomy, but the result of a prior reconfiguration of the external constraint. The renewed accumulation of sterling balances that had begun with the 1968 Basle deal was now accelerated in response to the OPEC shock. Between 1974 and 1976, Labour’s commitment to maintaining output and demand resulted in a further expansion of the balances as newly enriched oil producers were encouraged to deposit their earnings into sterling. An expansion in public sector borrowing on capital markets and directly from oil producers permitted the continuation of expansionary government policies in the face of the oil shock and resulting external deficits.

The thesis argues that extent of the crisis was not determined solely by the turn in market opinion against sterling in 1975/76 but the change in the nature of the Anglo-American relationship and hence the accessibility to the resources of the IMF upon which Britain had traditionally depended to manage its external commitments. While recognising by 1975 that adjustment was required, Labour believed that it could proceed according to its own timetable and interpretation. Its response to the

¹⁸ Schenk *The Decline of Sterling* pp. 368, 378

¹⁹ *Ibid* p392

²⁰ *Ibid* pp.394-395

²¹ *Ibid* p415

external deficit was a continuation of post-devaluation strategy in which a competitive exchange rate would secure export led growth from demand flowing from the reflation of other major economies.²² As before, IMF resources would facilitate this period of adjustment without resorting to excessive deflation or protectionist measures. Labour was successful in expanding the IMF's low conditionality support facilities for oil related deficits.²³

However, growing ideological divergence with the US Treasury, exacerbated by conflict over how to respond to the OPEC shock, meant support packages arranged in 1976 via the G10 and IMF were more contentious. Significantly, by 1976 the process of international monetary reform had culminated in the demonetisation of gold and the formalisation of floating rates, allowing the US to contain sterling crises more effectively than under Bretton Woods.²⁴ Meanwhile the US Treasury interpreted Labour's use of international borrowing to defer adjustment as undermining its common front aimed at forcing down the oil price.²⁵ Viewing the socialist policies of the Wilson/Callaghan governments with distaste, senior advisors in the Ford administration attempted to tie British requests for support to greater institutional oversight of policy by the IMF, itself seeking a new role in managing adjustment now that its previous one of overseeing exchange rate pegs was redundant.²⁶

In response to these changed circumstances, Callaghan now prioritised resolving sterling's reserve role. This was the first time this had become the major aim of sterling policy rather than stabilisation of the monetary system or financing deficits.²⁷ This involved Labour in a fundamental disagreement with America over the narrative of what crisis exactly sterling was facing. While Callaghan blamed it

²² TNA T358/207 "Exchange Rate Strategy" 10 April 1975

²³ TNA T354/367 "Tel No 3189" 1 October 1974

²⁴ Margaret de Vries *The International Monetary Fund 1927-1978 Cooperation on Trial* (New York: IMF, 1985) pp 770-771

²⁵ FRUS 69-76 Vol. E-15 Part 2 "Memorandum From Secretary of the Treasury Simon to President Ford" 15 November 1976

²⁶ FRUS 69-76 Vol. 31 "Memorandum from the Under Secretary of State for Economic Affairs (Robinson) to Secretary of State Kissinger" 29 March 1976

²⁷ TNA PREM 16/801 "Transcript of a Telephone Conversation Between the Prime Minister and the Chancellor of the Duchy of Lancaster" 18 November 1976

on the existence of the sterling balances (ignoring the role Labour played in their recent accumulation), the US blamed over-expansionary domestic policies that destabilised confidence.²⁸ Although Callaghan was forced to accept coming to terms with the Fund as a prerequisite for any further support, he proved adept in threatening the collapse of the agreement if an additional facility was not forthcoming.²⁹ In return for a commitment to prevent any renewed accumulation, Ford gave backing to a new Basle facility that used the 1968 deal as precedent.³⁰ Supported by Britain's offer of foreign currency bonds to facilitate diversification, the result was a reduction by 1979 of sterling held abroad to working balances.³¹ The true significance of the 1976 crisis therefore is reinterpreted as the resolution to the process of international monetary reform and evolution of sterling balances that had occurred since devaluation in 1967.

6.2: Oil Crisis and the 1974 General Election – December 1973 – April 1974

A new period in international monetary relations was inaugurated by the first OPEC oil shock which occurred at the end of 1973. A four-fold rise in oil prices resulted in a dramatic shift in the terms of trade between oil producing and oil consuming economies as well as the impact of 'stagflation' – stagnating output combined with accelerating inflation that traditional Keynesian prescriptions for pump-priming seemed ill-equipped to deal with.³²

²⁸ TNA T381/6" "Note of a Discussion" 3 October 1976

²⁹ TNA PREM 16/805 "Note of a Meeting Held a Number 11 Downing Street" 3 December 1976

³⁰ FRUS 69-76 Vol. E-15 Part 2 "Memorandum From the President's Assistant for National Security Affairs (Scowcroft) to President Ford" 18 December 1976.

³¹ TNA T381/99 "Official Sterling Balances" 24 Nov 1978

³² The economic effect of 'stagflation' impacted developed economies on multiple fronts. The huge external surpluses accruing to the OPEC states were deflationary, both for individual oil consuming countries and the global economy at large. Given the high dependence of Western economies on oil, the short run price elasticity of demand for oil was low: higher prices translated directly into higher revenue for oil producing states rather than reduced exports. In oil consuming states, higher energy prices squeezed consumption of other goods and services, resulting in a fall in the standard of living. At the same time oil producers, due to their size and development, could only absorb a fraction of their increased revenues in the form of imports of goods and services from oil consuming states. The result was an increase in the global rate of savings, and a deflationary effect on the global economy. However, the rise in energy prices and later in commodity prices (as other primary producers sought to imitate OPEC) also drove up the rate of inflation across industrialised economies, see Edmund Dell *A Hard Pounding: Politics and Economic Crisis 1974 – 76* (Oxford: Oxford University Press, 1991) pp198 – 199; Office of the President *Economic Report of the President* (Washington, D.C.: U.S. Government, 1975)

Some countries adjusted better than others, depending both on the policy mix adopted as well as their relative dependency on energy and commodity imports. Differential rates of inflation made managing currency pegs more difficult and this had consequences for attempts to re-fix exchange rates, both in the wider global monetary system and with European attempts to move towards monetary union.³³ The removal of the discipline of the exchange rate pegs opened space for more discretionary monetary policy, leading to faster money growth and inflation and prompting the IMF to consider new rules and methods to secure adjustment for unbalanced economies.³⁴

In Britain, the most immediate impact of the oil shock was to give another twist to the nation's increasingly disputatious industrial relations. The Heath government was involved in an acrimonious dispute with the miners and the rise in energy prices inevitably strengthened the union's negotiating position. One representative asked Heath "why can't you pay us for coal what you are willing to pay the Arabs for oil?"³⁵ A work to rule initiated by the miners' union had led to dwindling coal stocks and the government resorted to a three day working week between January and March 1974 to conserve energy. In response Heath called a general election, attempting to regain legitimacy under the slogan "Who Governs?" This was perhaps a legitimate question given the circumstances but not one to inspire confidence when asked by the Prime Minister.³⁶

Despite the evident conflict between the unions and the Conservative government, Heath's campaign proved remarkably moderate. As Andy Beckett has noted, "Heath wanted to assert the government's authority over the miners, but he did not want to crush them utterly." Wilson's Labour party won the election by appearing even more conciliatory, portraying Labour as the party that could do business with the unions.³⁷

³³ Eichengreen *Globalizing Capital* p155

³⁴ James *International Monetary Cooperation* p260

³⁵ Beckett *When The Lights Went Out* pp131 -132

³⁶ Vernon Bogdanor "The Fall of Heath and the End of the Post War Settlement" in Stuart Ball and Anthony Seldon [eds.] *The Heath Government 1970-74 A Reappraisal* (London: Longman, 1996) p371

³⁷ *Ibid* pp150 – 151; Although, as the incoming Chancellor Denis Healey noted in retrospect, Labour's low share of the vote meant perhaps "the electorate was trying to tell us something," at the time there was little vocal

For the second time in his career, Wilson inherited an economy from the Conservatives in serious trouble. Recession, rising unemployment and inflation combined with a ballooning balance of payments deficit.³⁸ As with his refusal to devalue in 1964, Wilson has been criticised for not taking more prompt action on the rate of government spending and inflation. Douglass Wass, who was Permanent Secretary of the Treasury throughout the IMF crisis, notes that of developed nations only Italy and Britain aimed to maintain levels of demand following the oil shock, and significantly, were the only economies needing assistance from the IMF in subsequent years.³⁹ According to Andy Beckett, the inability of the Labour party and Treasury to absorb the implications of the oil crisis meant most of 1974 passed without a fundamental reappraisal of economic policy.⁴⁰

Once again however, Wilson's freedom of manoeuvre was limited by political considerations. The February election saw Labour taking only 4 seats more than the Conservatives, short of an overall majority. Unable to form a stable government even with Liberal support, Wilson was forced to call a further election in October which gained him an overall majority of just 3 seats. This was hardly a mandate for radical economic surgery.⁴¹ Indeed, the leftward drift of the Labour party during its years of opposition meant Wilson had to tread carefully with respect to the expectations of his own party. The most immediate priority given the circumstances was to re-establish some form of normalcy regarding industrial relations. Labour's key industrial relations policy was the Social Contract. In return for unions moderating wage demands, Labour would repeal Heath's hated 1971 Industrial Relations Act while committing to welfare spending that would secure living standards for the working class.⁴² As such there was little immediate movement on the deficit inherited from

support for alternative free market policies of the kind implied by monetarism beyond certain marginal sections of the Conservative party and free market think tanks, Denis Healey *The Time of My Life* (London: Michael Joseph, 1989) p372.³⁷

³⁸ Wass *Decline to Fall* p42

³⁹ Wass *Decline to Fall* p39

⁴⁰ Beckett *When The Lights Went Out* pp152

⁴¹ Seat distribution was in part the result of the eccentricities of the British electoral system – Labour actually had a smaller share of the vote than the Conservatives in the February election while the Liberals gained only 14 seats on the basis of 19% of the vote – Skidelsky *Britain Since 1900* p314

⁴² Newton *The Reinvention of Britain* p102

Heath and Wilson accordingly looked to economic diplomacy to expand demand for British goods with lines of credit to finance deficits.

Britain's external position was in some ways strengthened by the impact of the OPEC oil crisis. Foreign exchange activity greatly increased as large British oil companies like Shell and British Petroleum made royalty payments of up to \$800m per month. On the other hand, the role of London as a leading financial centre meant Britain attracted dollar deposits in Eurodollar markets from the oil producers as part of their expected \$60bn earnings in 1974.⁴³ Sterling remained stable across the year and reserves were accumulated.⁴⁴ Accordingly, the Chancellor had little to say about the size of the rapidly expanding current account deficit during his first budget in April 1974. As Douglass Wass noted, the figures involved "would have caused consternation to policy makers of an earlier generation. The Chancellor simply focused on his ability to finance it."⁴⁵

Nevertheless, the OPEC funds moving into sterling did raise the possibility of exchange risk further down the line. Shortly before the budget, Healey wrote to Wilson notifying the PM of his decision to extend the guarantee of the sterling balances made under the Second Group Arrangement for a further 9 months. Although conceding that the previous unilateral extension had proved an expensive policy due to the weakness of sterling and that his preference was to be rid of the guarantees, Healey believed it was right to do so until additional lines of borrowing had been set up. The new extension was once again taken unilaterally but applied to a lower level of balances and was expressed in an effective rate for sterling rather than the spot dollar rate.⁴⁶ Throughout the year funds from the oil surpluses continued to be deposited into sterling, boosting the currency in the short term but adding a potential source of instability for the future.⁴⁷ Britain also developed direct financing links with the oil producers themselves, notably the Saudis who lent \$1.2bn to the

⁴³ *Cappie Bank of England* p719

⁴⁴ *Cappie Bank of England* pp. 720 - 721

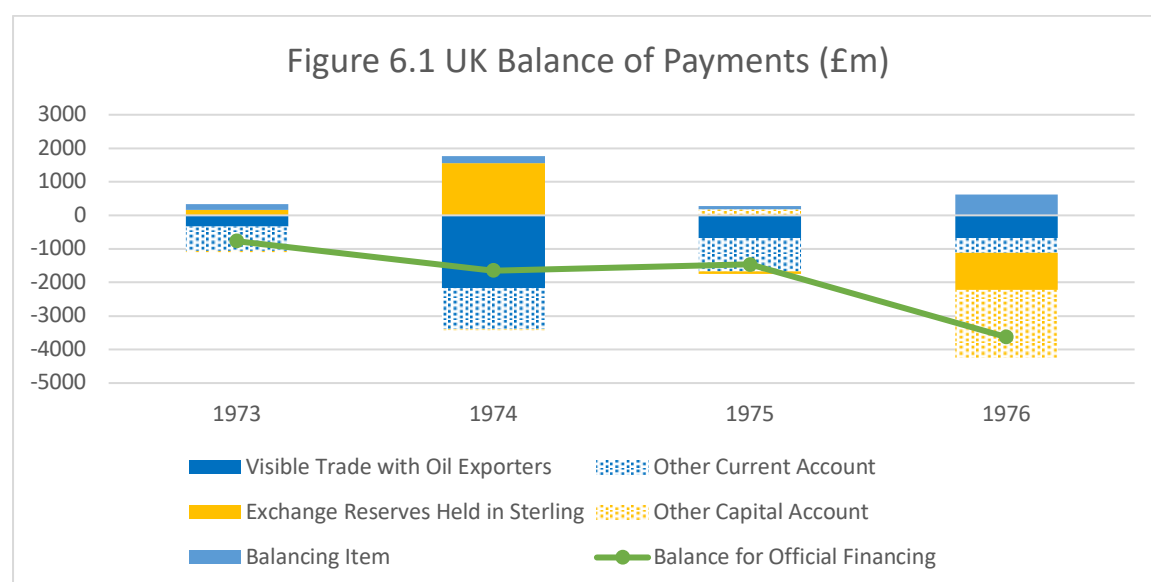
⁴⁵ *Wass Decline to Fall* p44 - 45

⁴⁶ TNA PREM 16/38 "Official Sterling Balances" 13 March 1974

⁴⁷ TNA PREM 16/49 "Petrodollars" 23 October 1974

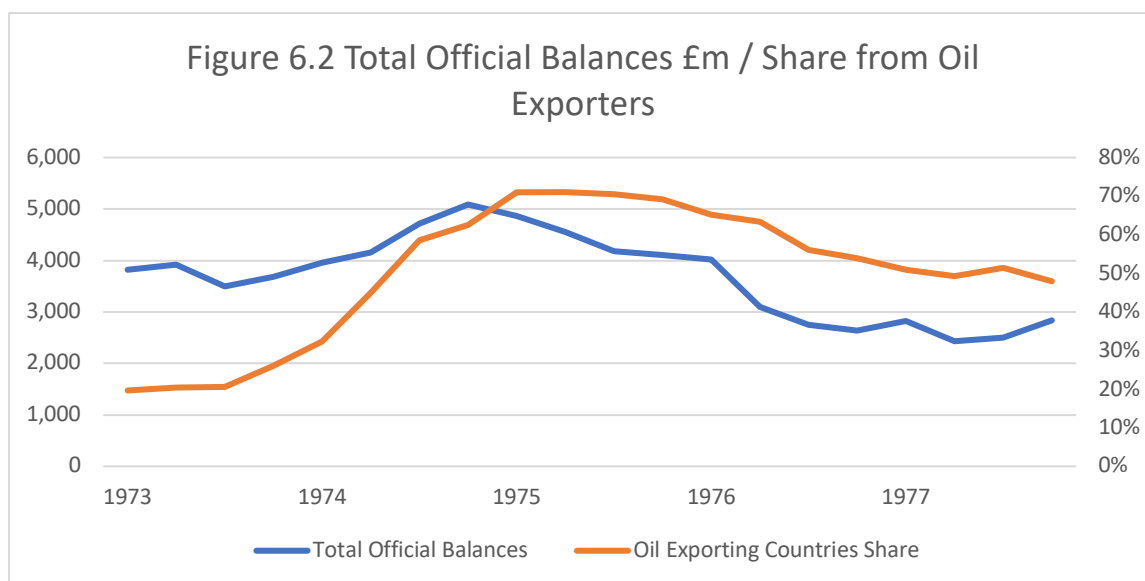
nationalised industries between 1973 and 1976, as well as Iran with whom a deal to lend \$1.4bn in three tranches over three years was agreed in 1974.⁴⁸

Wilson therefore continued Heath's policy of prioritising the needs of domestic expansion, taking advantages of new sources of international finance with which to delay or defer adjustment. As Figure 6.1 shows, in 1974 increased foreign holdings of sterling (driven by British public sector borrowing abroad) was enough to offset the oil-related current account deficits. This however resulted in a fresh build up in the level of sterling balances, and their accumulation in a small number of oil producing states (see Figure 6.2)



Source: Central Statistical Office *United Kingdom Balance of Payments 1979* (London: HMSO, 1980) Table 1.3 "Analysis of Capital Transactions and Official Financing", Table 2.3: "Geographical Analysis"

⁴⁸ Cappie *Bank of England* p727



Bank of England *Quarterly Bulletin* 1977 Q1, "Table 19, Exchange Reserves in sterling; and banking and money-market liabilities in sterling to holders other than central monetary institutions, Bank of England *Quarterly Bulletin* 1979 Q1 "Table 15: Exchange Reserves in sterling; and banking and money-market liabilities in sterling to holders other than central monetary institutions

For the time being confidence in sterling meant Labour could draw upon this source of finance to maintain government spending. Nevertheless, the removal of Britain's military ties to these states in 1971 meant these holdings were now dependent on the relative attractiveness of inducements on offer. Britain's increased dependence on foreign finance raised the possibility of market confidence constraining policy in the future. To counter this, Britain looked to secure other, institutional sources of support.

6.3: Anglo-American Relations and the Response to the OPEC Crisis –

January 1974 – December 1974

Labour's return to power meant a renewed focus on Anglo-American relations.⁴⁹ However a marked divergence in both the two countries' economic fundamentals, as well as the ideological outlook of their governments complicated the relationship. As much as the OPEC crisis itself, this divergence forms the context that is essential to understand the British response to the IMF crisis. Initially

⁴⁹ Newton *The Reinvention of Britain* p111

disagreement centred on the proposed response (both domestic and foreign) to the oil crisis and subsequently on the nature of the 1975/76 sterling crisis.

The impact of the oil shock was felt differently in America. The US was less reliant on imported energy supplies and therefore could afford a more confrontational attitude with the OPEC states. As one Treasury memo noted, “for us the wolf is at the door, for the United States it is not even at the bottom of the garden.”⁵⁰ The Americans accordingly looked to bring the oil price back down. They did not wish to entrench the higher price by creating sources to finance it and believed external deficits resulting from the crisis served to reinforce solidarity among oil consuming states. A joint front was needed to force down the price.⁵¹ In contrast, Britain was dependent on oil imports and while the rise in the price spurred on investment in North Sea oil fields, in the immediate term the increased energy prices exacerbated the current account deficit inherited from Heath while giving another twist to the inflationary spiral.⁵²

Ideologically, Labour had moved leftward during its time in opposition while the US government had moved rightward under Nixon and his successor Gerald Ford, who took power following the former’s resignation in August 1974. Labour’s Social Contract implied both large scale government spending and a key role for the interests of unions in formulating policy.⁵³ Within the US Treasury there was growing support for neoliberal solutions to international trade and payments. At a meeting of the Committee of 20 in January 1974, Secretary of the Treasury George Schultz called for freeing markets as much as possible to facilitate recycling oil funds back to borrowers.⁵⁴ Following the meeting, Nixon approved removing the final controls on capital exports, a campaign promise from the 1968 election.⁵⁵ Schulz’s successor as Secretary of the Treasury Bill Simon, described as “far to the right of Genghis Khan” by Healey, consistently lobbied Ford to take a harder line with regards to

⁵⁰ TNA T354/125 “The Energy Crisis and its Consequences” 15 January 1974

⁵¹ FRUS 69-76 Vol. 31 “Memorandum for the President's File” 21 January 1974

⁵² TNA T354/125 “The Energy Crisis and its Consequences” 15 January 1974

⁵³ Newton *The Reinvention of Britain* pp 81-82

⁵⁴ TNA T354/125 “Tel no Remac 7” 13 February 1974

⁵⁵ FRUS Vol. 31 “Memorandum for the President's File” 21 January 1974

the British.⁵⁶ Simon, together with under-Secretary Ed Yeo were advocates of neoliberal economic policy and like Arthur Burns at the Fed, viewed what they saw as the socialist temperament of the Labour party with distaste.⁵⁷

Accordingly, Labour had different priorities in both its domestic response to the crisis and objectives for foreign economic policy. Wilson's commitment to maintain full employment as part of the Social Contract meant Labour focused on the deflationary impact of the oil shock and sought to resist the reduction in demand it implied. Accordingly, Labour sought to encourage other countries to maintain demand in their economies while developing institutional sources of finance to enable oil importing economies to cope with the resulting balance of payments deficits. This put the British in conflict with those who focused on the inflationary aspect of the oil shock and the need to restore control over price rises, even at the cost of higher employment.

The initial international response to the oil shock mirrored British concerns that levels of employment and output should not be sacrificed in the name of restraining inflation. It was unclear how long oil prices would remain high: OPEC states had tried on several occasions to corner the market and had not been successful before. The meeting of the Committee of 20 in Rome in January appeared to agree with British arguments. Recognising that there was an incentive to clear the deficits arising from the rise in oil prices, the communique argued that nevertheless simultaneous efforts to do so on the part of the developed economies would generate the risk of worldwide deflation and/or trade distortions. Accordingly, members agreed

not to adopt policies which would merely aggravate the problems of other countries....to pursue policies that would sustain appropriate levels of economic activity and employment, while minimising inflation.⁵⁸

⁵⁶ Healey *Time of My Life* p419

⁵⁷ FRUS Vol. 31 Draft Memorandum From President Nixon to the President's Assistant for National Security Affairs (Kissinger) 10 March 1973

⁵⁸ Mark D. Harmon *The British Labour Government and the 1976 IMF Crisis* (Basingstoke: Palgrave Macmillan, 1997) p66

Notwithstanding this agreement, it soon became clear that other economies were focusing more on the inflation aspect of the declaration and were resistant to British arguments in favour of institutional funding out of the fear it would entrench the higher oil price. At a meeting of the OECD in February the debate turned on whether the oil price rises would be deflationary or inflationary. The British position was that they were decidedly deflationary, with Atkinson of the Treasury complaining that countries were responding in too “conventional” a manner to what was decidedly an unconventional situation. The oil importing states had no option but to run large current account deficits for some time; once this was accepted there was no need to reduce spending in the short term. Instead, the British called for a concerted plan to increase demand in line with the growth in capacity.

This line was countered by Stein of the US who accepted the British argument that the price hike would impact demand but raised the issue of the appropriate policy response. As the Nixon administration had dismantled its wage and price control apparatus it would have to rely on demand management to restrain inflation. The Germans, who had always been lukewarm Keynesians, were even more alarmed by the price rises. Control of prices was paramount; they expected much of the liquidity flowing out to oil producers would return in the form of increased demand for exports and investment and they did not want to pre-empt this by raising domestic demand.⁵⁹

The British were unable to use direct meetings with their American counterparts to convince the latter to focus on unemployment. Meeting with Kissinger in July, Healey outlined his main concerns as the prospect of a trade war and the impact of price rises on demand. He complained that the Americans appeared “obsessed” with the inflationary effect of the oil crisis and were not paying enough attention to the demand effect.⁶⁰ When Harold Lever, the Chancellor of the Duchy of Lancaster, met Simon in Washington he found the US Secretary “breezily optimistic” about the oil

⁵⁹ TNA T354/125 "Economic Policy Committee Meeting" 21 February 1974

⁶⁰ TNA T354/367 "Record of a Conversation" 8 July 1974

crisis, convinced that the OPEC monopoly would break down since they would not be able to agree to restricting production to maintain prices. Lever urged Simon to address the monetary problems arising from the oil producers' surpluses to which Simon gave evasive answers concerning the difficulty of getting Congress to accept any progressive policy.⁶¹ Wilson ended the year with a telegram to Ford in which he described the US economy as the "motor of the industrial world," and worried that the price rise was having an impact on the American economy, resulting in a "motor which is indeed slowing down." He urged Ford to undertake measures that would restore confidence of business and labour by demonstrating the government would intervene to prevent the recession turning into a depression.⁶²

The OPEC crisis marked the first sign of the growing divergence between the US and UK. America's political objective was to force the oil price back down and favoured market intermediation to provide finance for oil related deficits in the meantime. In contrast, the prospect of North Sea oil meant Britain instead to look benefit from high oil prices in the long run and accordingly sought expansion of institutional finance coupled with international borrowing to maintain output and finance deficits while they waited for this source of income to come on stream. In contrast, the neo-liberal US Treasury believed borrowing from oil producers and support from the IMF allowed Britain to defer adjustment, undermining American attempts for a common front to force back down the oil price. This perception was to weaken Britain's hand in subsequent negotiations with the IMF.

6.4: Culmination of IMS Reform— *March 1973 – January 1976*

These different perspectives fed into differing objectives and criteria for success in international monetary reform. While the British looked to expand international sources of finance to tide their economy over until higher exports and oil production relieved some of the pressure on the balance of payments, the Americans sought mainly to ward off any efforts by the French to restore gold to

⁶¹ TNA T354/367 "Note for the Record" 26 July 1974.

⁶² FRUS 69-76 Vol. 31 "Message From British Prime Minister Wilson to President Ford" 31 December 1974

the heart of the system and re-establish convertibility and fixed rates for the dollar. Success in their major objectives for reform by 1976 meant the Americans were less threatened by the prospect of a sterling crisis than they had been previously and less inclined to help for ideological reasons.

The OPEC oil shock marked an end to any prospect of resurrecting Bretton Woods. The high and differing rates of inflation meant fixed exchange rates were now untenable without unprecedented levels of support and coordination. The world moved towards a floating dollar standard for lack of any alternative commanding widespread support. However, this was not before the contentious role of gold in the system was resolved, largely in America's favour. The British did not engage directly in this debate, conserving their political capital for their attempts to develop institutional financing (see below). It is worth considering however to understand how the American objectives for international reform had largely been achieved by 1976, lessening the threat posed by destabilised British economy and therefore setting the context for the debates over the IMF bailout and resolution of the sterling's reserve role.

The rise in prices initially strengthened the hands of the French who argued that a revaluation of the official price at which its sizable gold reserves were valued was urgently required. In addition, approval of the resumption of official gold sales would allow the French to draw down their gold stocks to pay for the balance of payments deficit resulting from the rise in energy prices.⁶³ Selling their gold at market prices would allow the French to settle their intra-EEC debts while paying for oil without incurring future liabilities to OPEC states.

Although reluctant to concede a rise in the official gold price, believing it would be more likely to entrench the metal's role in world payments than phase it out, the Americans were keen to prevent any bilateral deals between the Europeans and OPEC states which might undermine US proposals for

⁶³ FRUS 69-76 Vol. 31 "Note From the Deputy Assistant Secretary of State for International Finance and Development (Weintraub) to the Under Secretary of the Treasury for Monetary Affairs (Volcker)" 6 March 1974

consumer solidarity.⁶⁴ In April 1974 a meeting of EEC finance ministers proposed that governments be permitted to buy and sell gold to each other at the market price. In addition, they would also be allowed to buy from the market but to minimise fluctuation in the gold price there would be agreement that no central bank would be a net buyer of gold.⁶⁵ Simon viewed these proposals favourably, noting to Burns that the accession to power of “financially orientated” leaders in Germany and France offered a good opportunity to move reforms forward.⁶⁶ In August Simon proposed within the Nixon administration that the Americans concede free trading in gold between governments in return for the IMF selling its own gold stocks. Simon believed that doing so, the US would win support for its provisions to ensure the metal was phased out from the institutional framework of the monetary system.⁶⁷

Further progress was made at a summit with the French at Martinique in December. Giscard d’Estaing, who had become the French President in May, denied he was in favour of restoring the gold standard. He therefore wanted to change the rules on gold without undermining the progress of monetary reform.⁶⁸ As a briefing for Ford noted, Giscard was less insistent on gold having an official role than previous French presidents but still wanted the freedom to buy and sell it. The Americans conceded these points in return for prohibition on fixing the price of gold that might re-establish it via a back door as well as a transitional period that limited net purchases of gold.⁶⁹

Final agreement was reached the following year. The Interim Committee of the IMF, which advised on amendments to the Fund’s Articles of Agreement, agreed in August 1975 to release one third of IMF gold stock, half of which would be returned to members while the other half would benefit Less

⁶⁴ *Ibid.*

⁶⁵ FRUS 69-76 Vol.31 “Memorandum From the Under Secretary of the Treasury (Bennett) to Secretary of the Treasury Simon” 09 May 1974

⁶⁶ FRUS 69-76 Vol.31 “Memorandum From the Under Secretary of the Treasury (Bennett) to Secretary of the Treasury Simon” 09 May 1974

⁶⁷ FRUS 69-76 Vol. 31 “Memorandum by the Under Secretary of the Treasury for Monetary Affairs (Bennett)” 05 August 1974

⁶⁸ FRUS 69-76 Vol. 31 “Memorandum From Edwin Truman of the Federal Reserve System Board of Governors Staff to the Chairman of the Federal Reserve System Board of Governors (Burns)” 18 December 1974

⁶⁹ *Ibid.*

Developed Countries.⁷⁰ In his response to a letter from Ford, Wilson expressed satisfaction at the outcome of the meeting, “in particular the successful resolution of the gold issues that have proved so intractable in the past.”⁷¹ Revision to the IMF’s Articles of Agreement in January 1976 gave formal recognition to the end of gold by formally phasing out the metal from international payments, including the sales of the Fund’s own gold reserves.⁷²

At the same time as achieving a long-standing objective in the demonetisation of gold, the Americans also made progress on formalising the role of floating exchange rates in the post-Bretton Woods system. Again, the French provided the principal antagonists. The French believed that new par values should be established by the IMF, with governments obliged to intervene to maintain the value of their currencies against these pegs. To the Americans this would promote inflexibility in adjustment, while Simon was aware of Congressional opposition towards any amendment to the IMF articles which did not authorise floating the dollar.⁷³

In return for its concessions on gold trading, the American view prevailed on amendments to the IMF’s provisions on adjustment. This resulted in a flexible and permissive exchange rate system, involving no compulsion on states to intervene in foreign exchange markets. The 1976 meeting of the IMF Interim Committee held in Jamaica in January, which gave formal approval of the move towards floating, made no corresponding settlement on liquidity, effectively ending progress towards a system in which the SDR played any meaningful role.⁷⁴ Reporting to President Ford in January, Simon claimed the agreement was the “first sweeping revision of our international agreements” since the original Bretton Woods conference.⁷⁵ At the same meeting at which measures to phase out gold in international payments were adopted, including sales of the IMF’s

⁷⁰ TNA CAB 133/459 "International Economic Problems: Monetary" 31 August 1975

⁷¹ TNA PREM 16/356 "Letter from Wilson to Ford" 30 August 1975

⁷² FRUS 69-76 Vol. 31 "Memorandum From Secretary of the Treasury Simon to President Ford" 13 January 1976

⁷³ FRUS 69-76 Vol. 31 "Memorandum From Secretary of the Treasury Simon to President Ford" 03 June 1975

⁷⁴ James *International Monetary Cooperation* pp. 269-270

⁷⁵ FRUS 69-76 Vol. 31 "Memorandum From Secretary of the Treasury Simon to President Ford" 13 January 1976

gold reserves, floating rates were also given recognition.⁷⁶ This was the culmination of the reform process that had begun following the establishment of the C-20 in 1972. Despite anticipations, there was no provision for substitution of reserve currencies into SDRs.⁷⁷ Instead the main significance was the formal recognition that the Bretton Woods system of pegged exchange rates was no longer appropriate and was replaced by floating as the primary method of adjustment.

The US had therefore achieved two long standing objectives: removing the role of gold from the international monetary system (and with it any prospect of restoring dollar convertibility) while formally establishing flexibility in adjustment. The British had largely stood back from these debates but generally sided with the Americans on exchange rate flexibility and while in favour of gold revaluation did not share the French's totemic devotion to the metal. In removing any commitment of the dollar towards gold, these reforms acquiesced in a fiat, dollar standard. As such sterling crises could now be more effectively contained than under Bretton Woods.⁷⁸

6.5 Britain and Intermediation Debates *June 1974 – January 1975*

Despite the implications that reform of gold and adjustment had for sterling, Britain did not directly intervene much in the process. This was to preserve political capital for debates over the role of the IMF in intermediation between oil exporting and importing states. This was to prove a successful example of British economic diplomacy, with Healey leading European opinion and handling American objections to secure fresh IMF support with minor conditionality. In doing so, Britain was able to secure additional source of finance that could manage the external constraint in 1976.

To consider the importance of intermediation we need to understand how the international system of trade and payments had been altered by the oil shock. The rise in oil prices overnight transformed the structure of the international economy. As the Saudi Oil Minister noted, "we are in a position to

⁷⁶ *Ibid.*

⁷⁷ Margaret de Vries *The International Monetary Fund 1927-1978 Cooperation on Trial* (New York: IMF, 1985) pp 770-771

⁷⁸ TNA T381/5 "Letter from W S Ryrie to Sir Derek Mitchell" 28 May 1976

dictate prices.... we are going to be very rich.”⁷⁹ If oil importing countries were to maintain demand and to avoid anti-liberal policies such as trade restrictions, competitive devaluations and a breakdown in trade and payments then to a certain extent the higher prices would have to be tolerated and resulting deficits financed. The money itself would come from the OPEC states – in effect “recycling” the money already paid out by the industrialised economies back to them. The way this would be facilitated was a source of debate pitting those favouring market led intermediation against those who preferred new institutional sources of funding.

The Europeans were more suspicious of market led intermediation. The French were concerned of conceding sovereignty to the markets in such an important area, while the Germans worried that the ability of banks to borrow via off-shore sources of finance would undermine anti-inflation policies.⁸⁰ Cold War imperatives meant concern for oil importing LDCs without the credit rating to borrow on the capital markets. Healey therefore looked to engage with existing initiatives underway in the IMF to secure financial support related to oil deficits, which could also support sterling.⁸¹

The main such initiative was the creation of a facility at the IMF with looser conditionality than attached to traditional lending facilities that would extend financing to countries experiencing balance of payments difficulties related to the oil price. This had been first proposed at the 1974 Rome meeting by IMF director Johan Witteveen. A facility set up to this end (known as the Witteveen scheme) had proved a success with 38 countries using the scheme during its first year of operation.⁸² Healey wanted it renewed and expanded as a source of finance to cover the ongoing deficits (referred to as Witteveen II). An IMF paper in late 1974 recommended a facility in the range of \$7 – \$9.5bn, raising funds from OPEC states and those industrialised nations in surplus. However, this ran into opposition from the US which disliked financing oil deficits for fear of legitimising them and displayed a preference for private market solutions. In response to the IMF’s proposals, the US

⁷⁹ Allen Matusow *Nixon’s Economy* p258

⁸⁰ TNA T354/367 “Eager Saving 358” 30 September 1974

⁸¹ TNA PREM 16/49 “The Petrodollar Question” 24 June 1974

⁸² Hickson *The IMF Crisis of 1976 and British Politics* p64

brought forward its own plan for a Financial Support Fund [FSF] which would raise funds from OECD nations only to act as a lender of last resort to nations in severe difficulty. A key difference, and one which made it unpalatable to the British, was that it would come with strict conditionality.⁸³

Speaking to the press after a meeting in New York in September, the Chancellor claimed that there was a convergence of views towards his proposals, with both the Europeans and Americans showing enthusiasm for what was becoming known as the 'Healey' plan.⁸⁴ Despite the Chancellor's sanguine comments to the press, Armstrong in the Treasury expressed concern that the British were moving away from the Americans at a time when they should be staying close. As one of the main beneficiaries of oil dollar flows, British proposals for extra sources of financing could look like "special pleading," although Armstrong noted that if London recycled oil money on its own initiative it would bear the risk of debts turning bad.

According to Armstrong, the meeting in September had revealed the differences in the British and American positions, where even Healey's modest proposals for an IMF oil facility had been "received with horror."⁸⁵ Healey's advocacy of fresh institutional funding therefore risked the support of the Americans. However, despite their opposition to the scheme, the fear of being isolated during a time of great stress in the international economy and geopolitical tension meant the Americans softened their position somewhat at the start of 1975. Witteveen passed on to the British Treasury a report of his discussion with the US IMF Executive Director Bennett in which the latter expressed satisfaction over the supposedly increased conditionality provisions of the revised Witteveen II facility.⁸⁶ At a meeting of EEC Finance Ministers at Lancaster House on 7 January, Healey sounded out his European colleagues on the proposed IMF facility and secured unanimity on European support for Witteveen II in return for which they would give consideration to the US's proposed FSF. Healey was asked to act

⁸³ Harmon *The British Labour Government and the 1976 IMF Crisis* pp 72 - 74

⁸⁴ T354/367 "Tel No 3189" 1 October 1974

⁸⁵ TNA PREM 16/49 "Petrodollars" 23 October 1974

⁸⁶ TNA T354/566 "Eager Tel No 4" 02 January 1975

as spokesman in the forthcoming Washington G10 meeting, an example of successful British economic diplomacy in Europe in contrast to the Heath years.⁸⁷

Arriving in Washington in mid-January 1975, Healey presented a bullish face to the press, arguing that differences between the Americans and Europeans had been exaggerated and the IMF and FSF plans (now referred to respectively as the Healey and Kissinger plans) were complementary operating as they did on different time scales and to different objectives.⁸⁸ Behind closed doors, Healey had to push Simon and Burns hard but by 16 January he was able to announce to the press success in securing agreement to set up a \$25bn fund for industrial countries and a 5bn SDR IMF oil facility fund. The oil fund assumed that none of the big five industrialised countries of US, Britain, Germany, Japan, France would borrow money, but agreement had been reached that if these countries did require access then the Fund would lend on money from its existing resources.⁸⁹

In London, the Ministerial Committee on Economic Strategy agreed that the result of the Washington meeting was welcome, despite the limited size and duration of the resulting oil facility but expressed doubts that the proposed OECD scheme would ever be set up given likely opposition in Congress. This was prescient as the FSF was stuck in limbo after Congress failed to ratify it.⁹⁰ Thus although the oil facility did not entirely solve the problem of financing oil deficits, it was believed to make a contribution and one that would be drawn upon by the British themselves before too long.⁹¹ However, it set the tone for the future debates over the IMF standby and sterling balances arrangement, during which Simon and Yeo were keen to avoid Britain escaping IMF conditionality once more.

⁸⁷ TNA T354/566 "Tel No 31" 07 January 1975

⁸⁸ *The Times* 14 Jan 1974

⁸⁹ TNA T354/566 "Press Release" 16 January 1975

⁹⁰ FRUS 69-76 Vol. 31 "Memorandum of a Conversation" 4 June 1976

⁹¹ TNA T354/566 "Ministerial Committee on Economic Strategy" 23 January 1975

6.6: Sterling in Crisis – April 1975 – June 1976

Britain had maintained domestic peace through the first year of the oil crisis with the Social Contract, whereby borrowing had maintained external stability despite the expanding current account deficit. There had been some success expanding institutional sources of finance with limited conditionality via the IMF, but Britain also encouraged a further build up in the sterling balances among official holders while also drawing extensively on international capital markets. As such, although adjustment was flexible and liquidity plentiful, these extensive debts meant maintaining confidence in sterling emerged as the major constraint on British policy. This meant managing both access to institutional sources of finance as well as market sentiment. As the latter turned against sterling in 1975, Labour instead turned to institutional sources of financing, raising the potential for political conflict with the Americans.

Market sentiment was undermined by suspicions that Labour was attempting to engineer a devaluation. Labour had by this time decided that domestic government spending and monetary policy could not continue on their current trajectory and looked to external demand to fill the gap. Arguing that a downward trend in sterling's value was somewhat inevitable, a Treasury paper in February had highlighted the benefits of increased demand for exports that would result from a 10-20% devaluation. However, the government would also have to take responsibility for a policy that increased inflation and imposed losses on sterling holders. This would raise accusations over breaches of trust and making future financing harder to achieve. Accordingly, it was decided the best course of action would be to accede to sterling's decline and not to put up too much of a fight to prevent it, while avoiding giving the impression that the government was directly responsible.⁹² One April paper argued that three external factors would in any case drive the decline of sterling's value,

⁹² TNA T338/296 "A 20% Depreciation" 14 March 1975

namely narrowing interest rate differentials, a strengthening dollar and the market shorting sterling ahead of the 1975 referendum on EEC membership.⁹³

Labour had committed itself to a referendum on membership of the EEC in opposition which was now scheduled to take place on 5 June 1975. Sterling was expected to be weak in the build-up to the referendum, and the government planned to eschew major intervention to let the rate drift downwards. Following a positive vote on the referendum, during which short positions would be unwound, the Bank of England would intervene to prevent strong demand for causing the rate to rise. On 11 April, the Chancellor gave preliminary approval to this tactic of letting the rate depreciate during the referendum period.⁹⁴

The lack of firm commitment to defence of sterling raised market suspicions that the government was in fact attempting to engineer a depreciation. Reductions in interest rates at the end of April were taken to be a sign of the government's desire to bring down the rate and heavy selling erupted following the publication of an article in the *Sunday Times*: "Healey Ready to Let £ Drop."⁹⁵ The growing instability of sterling prompted a shift in government policy. As Healey told a TUC committee, "oil producers were simply not prepared to put their money into a country where its value could be undermined." Healey warned that if this did happen living standards would be reduced as well as recourse made to institutional borrowing with conditions imposed on economic policy.⁹⁶ In the discussions regarding the April budget, Healey and his allies in the Cabinet, notably Wilson, Callaghan and Roy Jenkins made the case for cuts to public expenditure to free up resources for exports as well as deal with the issue of confidence. The proposals for public expenditure cuts and a more robust anti-inflation strategy did not go unchallenged within the Cabinet. Tony Benn pitched his Alternative Economic Strategy whereby domestic demand and employment would be given priority and expansion protected through import restrictions, rationing of certain imported

⁹³ TNA T358/207 "Exchange Rate Strategy" 10 April 1975

⁹⁴ TNA T358/207 "Exchange Rate Strategy" 10 April 1975

⁹⁵ TNA T358/207 "Exchange Rate Tactics" 22 April 1975

⁹⁶ Harmon *The British Labour Government and the 1976 IMF Crisis* pp 92 – 95

materials, control of capital outflow and a downward float of sterling. If enacted, Benn's strategy would have represented an unprecedented shift in economic policy, effectively creating a 'siege economy' involving a level of government economic control not seen since Wilson's 'bonfire of controls' in 1948.⁹⁷

Ultimately however, Healey carried the day and the Cabinet endorsed the Chancellor's position that cuts in public expenditure of £1bn for 1975-1976 were necessary to forestall a collapse in confidence in sterling.⁹⁸ Announcing the cuts in the April budget and his intention to reduce £3bn from the PSBR 1976-1977, Healey stated the measures were necessary to take advantage of the increase in world trade he foresaw for the forthcoming year. Healey warned that while financing the deficit had not proved difficult in 1974, the supply of unconditional funds was not unlimited:

If we are to go on attracting such funds their owners must believe that the value of the money they have placed with us is not threatened by the consequences of our policy actions or inactions.⁹⁹

Controlling inflation was vital to this endeavour. Healey was critical of excessive wage settlements for the damage they imposed on Britain's competitiveness and warned that unless the voluntary policy achieved stricter adherence the result would be higher unemployment and lower living standards all round.¹⁰⁰ On 30 June 1975, as the Cabinet was considering an incomes policy, a massive bear attack erupted over sterling driven by diversification in official balances held by Kuwait and Nigeria. Meeting Healey at mid-day, Richardson informed the Chancellor that he feared "we might be faced with a real collapse in our position." Briefing his ministerial colleagues later that day, Healey warned them Britain's reserves could potentially be wiped out within 24 hours and that an immediate decision on counter inflation strategy was imperative to restore confidence in markets.¹⁰¹ Healey explained the position of sterling was "crumbling" and that an announcement was needed

⁹⁷ Newton *The Reinvention of Britain* pp.105-108, 115

⁹⁸ Harmon *The British Labour Government and the 1976 IMF Crisis* pp 92 – 95.

⁹⁹ *The Times* 15 April 1975

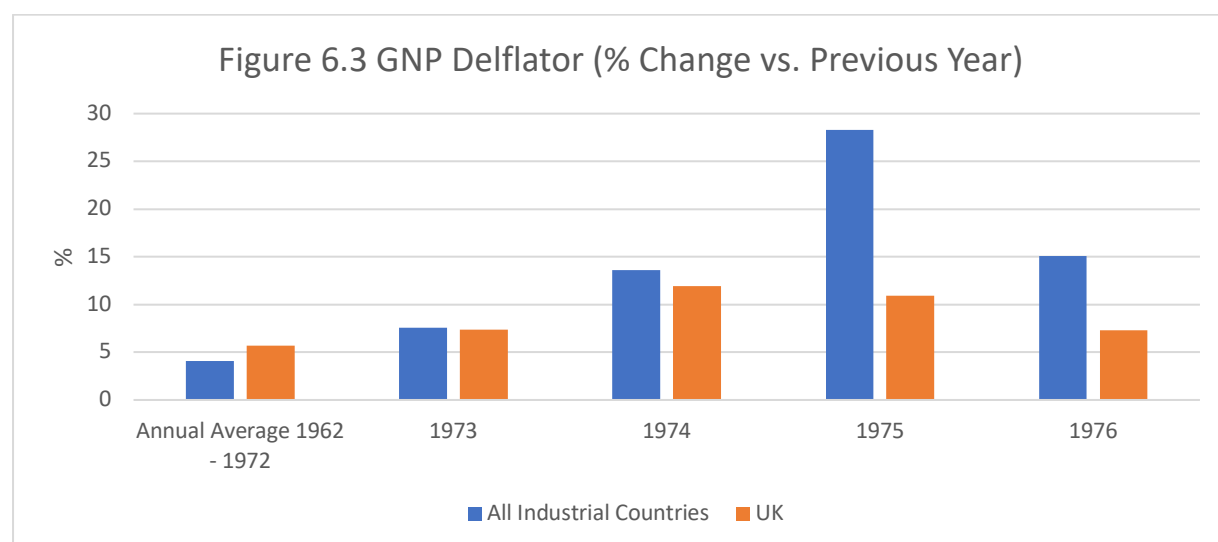
¹⁰⁰ *Ibid.*

¹⁰¹ Wass *Decline to Fall* p115

that day to stop the rot.¹⁰² After long discussions with the TUC, the unions eventually bought into a new incomes policy based on a flat rate increase in the weekly wage of £6. This was after being presented with the alternative of further public expenditure cuts and borrowing from the IMF which would insist on conditions that would prompt more unemployment and reductions in living standards.¹⁰³ The resulting White Paper based on agreement with the TUC drew the implications in stark terms:

This is a plan to save our country. If we do not over the twelve months achieve a drastic reduction in the present disastrous rate of inflation the British people will be engulfed in a general economic catastrophe of incalculable proportions.¹⁰⁴

As Wass notes, it was remarkably successful. The annualised rate of inflation falling from 20% to 10% by the second half of the year, with no breaches in its first year of operation.¹⁰⁵ However Britain's inflation rate remained well above comparable industrial countries into 1976 (who had also achieved reduced inflation, see Figure 6.3), threatening diversification of foreign holders of sterling into more stable currencies.



Source: IMF *Annual Report 1977*, Table 1 "Industrial Countries: Changes in Output and Prices, 1962 – 76"

¹⁰² TNA CAB/128/57/1 1 July 1975

¹⁰³ Harmon *The British Labour Government and the 1976 IMF Crisis* p107

¹⁰⁴ Wass *Decline to Fall* p 117

¹⁰⁵ *Ibid* p117

This continuous source of instability led Labour to approach the IMF for support, although at this stage only 'routine' drawings were being considered. In August 1975 Healey sent Treasury officials to Washington to look into drawing upon the IMF's oil facility as well as Britain's first credit tranche. The oil facility was due to lapse by March 76, meaning an application was needed soon if the British were to draw upon it.¹⁰⁶ Making his case for drawing on the oil facility, the UK's Executive Director to the IMF William Ryrie was clear that no major change in economic strategy was imminent. Referencing the IMF's own 1974 statement that countries should avoid excessive deflation, as well as the "political difficulties" enacting policies which "increased unemployment and reduced real income of the work force," the British were successful in gaining access to the first credit tranche as well as the oil facility. On 16 January 1976, Britain borrowed \$812m on its gold tranche, as well as a further \$1.16bn from the oil facility drawn the following week.¹⁰⁷

The period between the sterling crisis in April 1975 and the end of the year has been taken as a turning point in Britain's post-war economic history. Historical focus has been on the shift in the domestic priorities of economic policy as the commitment to maintaining demand through government spending was replaced, however reluctantly, with policies that aimed to maintain market confidence in sterling. Steve Ludlam has argued that Healey's 1975 budget marked a change in priority from bringing down unemployment to controlling inflation.¹⁰⁸ Mark Harmon agrees that the cuts announced in the April budget "constituted a turning point," cutting demand at a time when unemployment was still rising.¹⁰⁹

Chris Rogers goes furthest in arguing that Labour actively leveraged the threat of a collapse in sterling to secure domestic support for government retrenchment and incomes policy. Rogers downplays the significance of market turmoil in 1975, arguing that the year was characterised by two "non-crises". First, despite the Treasury's own preference for a decline in the exchange rate, its

¹⁰⁶ *Ibid* p153

¹⁰⁷ Burk & Cairncross *Goodbye Great Britain* p 18

¹⁰⁸ Ludlam "The Gnomes of Washington: Four Myths of the 1976 IMF Crisis," pp. 724 -725

¹⁰⁹ Harmon *The British Labour Government and the 1976 IMF Crisis* p95

fall was presented as demonstrating the need for a more robust anti-inflationary policy. Secondly, despite drawing on the oil facility out of prudence rather than any imminent financing gap, Britain accepted restrictions on its freedom of manoeuvre in domestic policy by agreeing to rule out import restrictions without prior approval of the Fund.¹¹⁰ Together this enabled the Labour leadership to pursue its preference for reducing expenditure and introducing an incomes policy while also preserving its political legitimacy by communicating to a domestic audience that there was no alternative, effectively ‘depoliticising’ the decision to abandon the Social Contract’s commitment to higher government spending.¹¹¹ Rogers argues this was actually an overtly political choice that enabled Wilson and his allies in Cabinet to face down Benn’s call for an Alternative Economic Strategy by presenting it as inconsistent with financial support from the IMF upon which Britain was said to depend.¹¹² Likewise, the problems presented by sterling’s international role proved useful in securing wider political support for domestic retrenchment aimed at reducing the external deficit, increasing sterling confidence and maintaining lines of credit.¹¹³

The argument advanced here is that the policy Labour pursued in 1975/76 was a continuation of its export-led growth strategy following devaluation. While Benn’s AES would have supposedly insulated the domestic economy from the impact of market opinion, allowing the prioritisation of domestic growth and investment over defence of the currency, this would have been at the cost of cutting off Britain from trade and the capital flows which had preserved the standard of living following the oil shock’s shift in the terms of trade. While the liberal trading system had survived the breakdown of Bretton Woods (Nixon’s surcharge was quickly abandoned), there was a renewed danger that countries might respond to the first major international economic crisis since the war with protectionist measures. Instead, Labour looked to secure both a competitive exchange rate and

¹¹⁰ Chris Rogers “From Social Contract to ‘Social Conctrick’: the Depoliticisation of Economic Policy-Making under Harold Wilson 1974-75” *British Journal of Politics and International Relations* (2009) Vol. 11(4) p649

¹¹¹ *Ibid* p636

¹¹² *Ibid* p644

¹¹³ Chris Rogers “Economic Policy and the Problem of Sterling under Harold Wilson and James Callaghan” *Contemporary Political History* (2011) Vol. 23 (3) p346

a shift of resources into the export sector to take advantage of a reflation of global demand they saw on the horizon.¹¹⁴

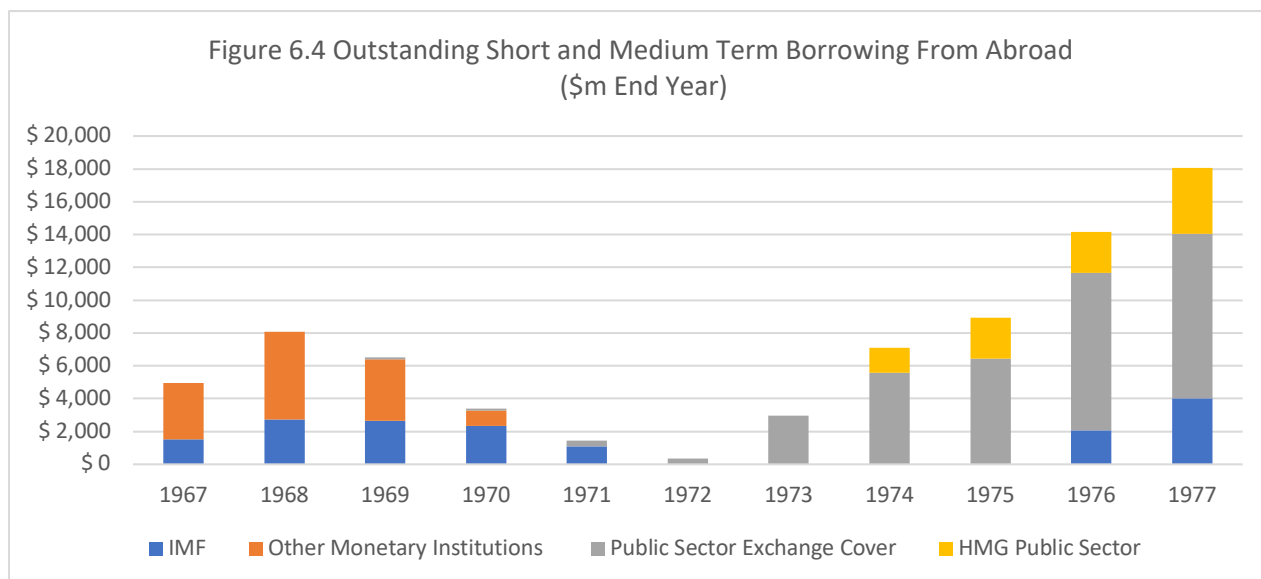
There was also the unresolved issue of the sterling balances. Pressure on the currency had begun in December 1974 following substantial sales by American oil companies operating in Saudi Arabia after being instructed by the Saudi government that all oil payments must be made in dollars.¹¹⁵ The timing was unfortunate as ARAMCO had recently acquired £226m which it had to dump on the market at once. Embarrassingly, the new policy was announced while Healey was in Riyadh and although the Saudi Ministry of Finance instructed the oil majors to make no further sales of sterling, this was, as the Treasury noted, “a bit late in the day.”¹¹⁶ Given the concentration of the balances in a small number of holders, decisions in a single country could have dramatic consequences for the rate. Controlling inflation was therefore vital to improve the incentive to hold the currency.

Therefore while the Labour leadership did need to buy support domestically for measures to bring down the public sector borrowing requirement, as we have seen in Chapter 4, this was never reduced to the levels achieved in 1968/69, while the public sector continued to borrow extensively on international capital markets (see Figure 6.4), increasing the need to maintain confidence in sterling.

¹¹⁴ TNA CAB 133/459 "Steering Brief" 6 November 1975

¹¹⁵ TNA PREM 16/49 "the November trade figures and the foreign exchange market" 10 December 1974

¹¹⁶ TNA PREM 16/49 "Letter from Paymaster General private sec to Butler Esq - PM Private Secretary" 13 December 1974



Source: Bank of England Quarterly Bulletin, 1976 Q1 "UK Official Short and Medium Term Borrowing From Abroad"; Bank of England Quarterly Bulletin, 1978 Q1 Table 24 "UK Official Short and Medium Term Borrowing From Abroad"

At the same time as domestic retrenchment, Labour simultaneously looked to foreign demand to secure growth via an export-led growth strategy, similar to its approach following devaluation. This dual strategy can be seen in the first summit of the G6 (France, West Germany, Italy, Japan, the US and the UK), held in November 1975 at Rambouillet, France summit. Despite Wilson's reservations, fearing it would descend into Franco-American arguments over "pursuit of fetishes about the monetary system," Labour saw a limited advantage in their participation.¹¹⁷ It would communicate to domestic audience the extent to which British economic problems were rooted in world problems, buying acceptance for tough remedies for inflation and the external deficit.¹¹⁸ There would also be potential to use the summit as a forum for discussing reflationary policies at a global level, notably from the Germans and Japanese.¹¹⁹

Labour's confidence that the right policy mix had been taken in the 1975 budget was demonstrated in the Treasury's preparation for Rambouillet. The Treasury argued it was inevitable there would be some deficit in government expenditure given OPEC and private sector surpluses resulting from the

¹¹⁷ TNA PREM 16/356 "Record of a meeting at Chequers"" 14 September 1975

¹¹⁸ TNA PREM 16/356 "Economic Summit" 14 September 1975

¹¹⁹ TNA PREM 16/356 "note of a meeting between PM and Chancellor" 6 August 1975

prevailing high saving ratio.¹²⁰ Nevertheless an improved forecast for inflation and the balance of payments as well as new measures to control public spending and protect sterling meant “a number of major problems in the United Kingdom’s economy are well on their way to solution.”¹²¹ As in 1968, Labour’s strategy depended on export led growth, which in turn depended on the demand in other industrialised economies. The British therefore aimed to talk up the danger of unemployment to maintain support for reflation in other countries, describing the 12.5m unemployed between them as a “tragic waste” of human resources,” while warning of the pressures for protectionism.¹²²

At the summit itself Wilson took an optimistic tone, noting improvements in the non-oil external deficit and the forecast decline in inflation following the agreement with the unions on incomes policy. The prospect of \$200bn reserves from North Sea oil meant the long-term balance of payments position was secure, while Wilson even joked of his ambition to become President of OPEC. In the immediate term, he asked his fellow delegates to take a “flexible” attitude to adjustment and that countries with balance of payments surpluses or “causal” countries with the ability to play a key role in the global economy expand domestic demand.

This however ran into outright opposition from the US represented by President Ford. Despite lauding the progress of the American economy, Ford also took pains to stress even faster growth would not lift the Europeans out of recession. The American position reflected concern that volatility in exchange markets would result in protectionism as countries sought to isolate their economies from the impact of global financial crises. A report for the President’s office noted it was imperative that countries like Britain and Italy “live more within [their] means,” but forecast major political difficulties for governments as they attempted to do so.¹²³ Simon was wary of being drawn into a European economic malaise, believing that the international financial crisis had its roots in

¹²⁰ TNA CAB 133/459 "Steering Brief" 6 November 1975

¹²¹ TNA CAB 133/459 "Economic Outlook: International and in Participant Countries " Brief by Treasury 5 November 1975

¹²² TNA CAB 133/459 "Steering Brief" 6 November 1975

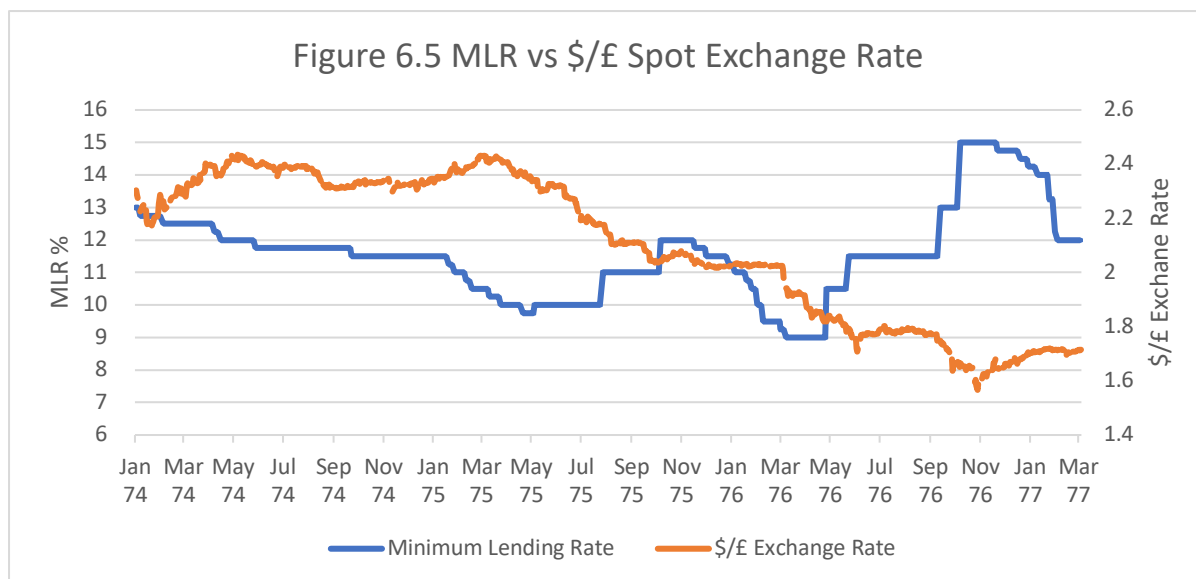
¹²³ FRUS 69-76 Vol. 31 "Memorandum From Robert Hormats of the National Security Council Staff to the President's Assistant for National Security Affairs (Scowcroft)" 17 March 1976

inappropriate domestic policies. Countries like Britain had reacted to the oil shock by heavy borrowing rather than adjustment and now the bill was due. Noting that the British government had “staked its future on the expansion of exports” to drive growth up and unemployment down, Simon believed that the recent fall in sterling was part of a deliberate effort to engineer a devaluation by the Bank of England. He subsequently issued a clear warning against competitive devaluations to the British, which he saw as contrary to the spirit of the new flexible system agreed under reforms to the IMF.¹²⁴ As such, in contrast to 1968/69 Labour’s efforts to engage economic diplomacy to negotiate the external constraint ran into determined opposition from the US. Ideological opposition was to subsequently determine the true scope of the crisis, rather than the scale of adjustment required.

A fresh crisis over sterling began in March 1976, in which once again diversification on the part of oil producers was compounded by market suspicions over Labour’s intention for sterling. A sell order from the Nigerian central bank prompted heavy selling in the market. A technical procedure, whereby the Bank of England had to recoup the Exchange Equalisation Account from which the Nigerian sterling had come by itself selling sterling was interpreted by the markets as a deliberately engineered attempt to drive down sterling. The reduction in the Market Lending Rate the next day, although also following technical rules to bring it in line with market rates, reinforced this view (see Figure 6.5).¹²⁵

¹²⁴ FRUS 69-76 Vol. 31 “Memorandum From Secretary of the Treasury Simon to the Economic Policy Board” 19 March 1976

¹²⁵ Wass *Decline to Fall* pp 178 – 180



Source: Minimum Lending Rate: Bank of England, "Changes in Bank Rate, Minimum Lending Rate, Minimum Band 1 Dealing Rate, Repo Rate and Official Bank Rate" [Online] <https://www.bankofengland.co.uk/-/media/boe/files/monetary-policy/baserate> (accessed 13 August 2019); Dollar/Sterling Exchange Rate: Federal Reserve, "G.5/H.10 – Foreign Exchange Rates" [Online] <https://www.federalreserve.gov/datadownload> (accessed 13 August 2019)

The decision to reduce interest rates took a heavy toll on the reserves. At the beginning of the crisis, the Bank had \$6bn in the armoury, of which \$1bn was from a recent drawing on the IMF's oil facility as well as the first credit tranche.¹²⁶ Following the resumption of heavy selling, the Bank spent \$1.2bn supporting the rate over the rest of the month in an attempt to prop up the currency.¹²⁷ Markets were not placated however and despite the rise in the MLR at the end of April, sterling continued to slide.¹²⁸ Markets were also unnerved by the surprise resignation of Wilson in April and a strong showing for the left-wing candidate Michael Foot in the subsequent election. After the third ballot Callaghan eventually became PM, but markets were not reassured by the 1976 budget which gave unprecedented influence to the unions by linking increases in tax allowances to the TUC respecting a 3% ceiling on pay rises.¹²⁹

Callaghan's inheritance was therefore not a happy one. Confidence in sterling was impinging on policy and markets remained unimpressed by measures taken so far. However, dramatic

¹²⁶ *Ibid* p195

¹²⁷ *Ibid* pp. 178 – 180

¹²⁸ *Ibid* p193

¹²⁹ Burn & Cairncross *Goodbye Great Britain* p35

retrenchment would undermine the support of the unions, bringing down the government. Only institutional finance could enable the government to stabilise the economy, support the exchange rate and manage diversification of the sterling balances. The failure of an independent European monetary policy since the collapse of Bretton Woods meant Labour was once again dependent on the American relationship. However, changes in the basis of Anglo-American relations since 1967 meant it was uncertain how would they respond to a request for further support.

6.7: Decline to the IMF: June 1976 – November 1976

Following Callaghan's election, the pound continued to slide, reaching a low of \$1.72 by the beginning of June. Cappie construes this slide as indicating a lack of strategy towards the exchange rate as well as lack of communication between the Treasury and the Bank.¹³⁰ Healey however resisted calls from the IMF for further government expenditure cuts, believing the correct policies were in place and required time to work through. This however exposed the British to the full weight of American disapproval. At a summit held in Puerto Rico at the end of the month, Callaghan conceded that fiscal and monetary restraint were required for the British economy to stabilise but questioned whether it was necessary in the doses being applied elsewhere in the developed world. He admitted he was very much concerned about what he saw as a "premature tightening up," given that export led growth was the Britain's "salvation" and would be jeopardised should her trading partners "overreact to inflation."

In response, Ford contradicted Callaghan openly, claiming pre-recession output had been surpassed and inflation was falling in a number of countries precisely because governments had refrained from over-expansive policies, despite domestic political pressure to do so. According to Ford, inflation caused recessions and ultimately unemployment. The current inflationary climate, while exacerbated by oil crisis, was the culmination of a decade in which governments overextended themselves in an attempt to drive up living standards and ameliorate social inequalities. Restoring

¹³⁰ Cappie *The Bank of England* p748

employment and output therefore required progress on inflation and, given the interdependence of the global economy, the most important contribution to the recovery he could make was to achieve stability in the US economy.¹³¹

The Americans therefore looked to use whatever leverage they had to impress on Britain's government the necessity of further corrective action. Greenspan, the Chairman of the CEA, wanted the US in concert with Germany to leverage the financial support required by Britain and Italy to impose correct domestic policies aimed at reducing public sector borrowing and monetary growth.¹³² Accordingly, when Richardson explored the possibility of drawing a \$3bn swap facility with the Federal Reserve on 3 June, Yeo looked to leverage this request to impose conditionality on British economic policy.¹³³ On 5 June, Yeo laid out the conditions in talks with Healey and Wass. The swap would be for 3 months, with only one renewal possible and in no circumstances would it be extended. Although opposed to the six-month limit, Callaghan conceded and agreed Britain would turn to the IMF if it needed further support at the end of the six-month period.¹³⁴

The swap agreement formed part of a wider \$5.3bn standby organised by the G-10 and was announced to the Commons on 7 June. Healey characterised the June loan as a "massive international endorsement of sterling" due to sterling being undervalued by the markets, but this was contradicted by American officials, who felt sterling's current market value reflected current British policies.¹³⁵ Burk & Cairncross believe the standby was designed to buy time, with the British hoping the measures already taken would work through the economy. In contrast, the Americans thought the time bought was to enact fresh measures.¹³⁶ Wass however dismisses the influence of the standby, claiming its announcement failed to restore confidence in sterling, while the reluctance

¹³¹ FRUS 69-76 Vol. 31 "Memorandum of a Conversation" 4 June 1976

¹³² FRUS 69-76 Vol. 31 "Memorandum from the Under Secretary of State for Economic Affairs (Robinson) to Secretary of State Kissinger" 29 March 1976

¹³³ *Ibid* p749

¹³⁴ Burn & Cairncross *Goodbye Great Britain* p43- 44

¹³⁵ Harmon "The 1976 UK-IMF Crisis: The Markets, the Americans, and the IMF" p10-11

¹³⁶ Burn & Cairncross *Goodbye Great Britain* p45

of the Treasury to draw on it due to its short maturity meant it had “little real effect on the situation.” Only \$1bn was drawn, for presentational purposes to boost the reserves.¹³⁷ As such both the markets and Labour drew the same impression, namely that the standby was not enough by itself to restore confidence in sterling. The markets, lacking their own apparatus of economic policy appraisal, looked to the IMF’s ‘seal of approval.’ Before the IMF negotiations had even begun however Labour were already reconsidering economic policy.

The failure of the standby to restore confidence in sterling meant a fresh reappraisal of domestic policy. At a meeting of the Economic Strategy (EY) committee, Healey made the case for a round of £1bn expenditure cuts, running into opposition from Benn who believed a loan from the IMF could be obtained with little conditions and advocated fresh expansion to lift the economy out of recession.¹³⁸ Eventually obtaining agreement from the full Cabinet, Healey announced the measures to the House on July 22, involving £1bn public expenditure cuts, a £1bn rise in National Insurance as well as a 12% target of money supply growth for the 76/77 financial year.¹³⁹

Markets continued to be unimpressed. Large scale selling resumed in September and while a three-month renewal of the central bank credit was easily obtained on 7 September, as per the conditions of the deal there would be no further extension when it expired in December.¹⁴⁰ Callaghan did not favour using the reserves to prop up the rate and heavy selling on 8 September followed agreement between Callaghan and Healey to cease intervention in sterling, overriding Bank of England objections. Despite a rise in the MLR from 11.5% to 13% on 10 Sept, by the time intervention resumed the following week the rate had fallen to \$1.72 and would continue to slide to \$1.67 by the end of the month. The Treasury was forced to accept that there was no substitute for intervention if a catastrophic collapse in the exchange rate was to be avoided.¹⁴¹

¹³⁷ Wass *Decline to Fall* p203

¹³⁸ Hickson *The IMF Crisis of 1976 and British Politics* pp. 92-96

¹³⁹ Rogers “The Politics of Economic Policy Making in Britain: A Re-assessment of the 1976 IMF Crisis” p980 -2

¹⁴⁰ Wass *Decline to Fall* p223

¹⁴¹ *Ibid* p225

On 29 September the government announced it would draw on its remaining credit tranches at the Fund, loans totalling \$3.9bn, of which \$1bn would be used to repay existing borrowing from the G10. The sense of crisis peaked before the IMF even arrived in town. Healey had planned to leave London on 28 September to attend a Commonwealth Finance Ministers meeting prior to the IMF annual meeting in Manila on 4 October. As sterling came under a renewed onslaught, Healey cancelled his trip while on the way to Heathrow.¹⁴² In order to demonstrate their commitment to resolve the crisis, Healey and Callaghan came out fighting at the party conference, to the open hostility of the left of the party. One portion of Callaghan's speech has in attracted a great deal of attention:

We used to think that you could spend your way out of a recession and increase employment by cutting taxes and boosting Government spending. I tell you in all candour that that option no longer exists, and that in so far as it ever did exist, it only worked on each occasion since the war by injecting a bigger dose of inflation into the economy, followed by a higher level of unemployment as the next step. Higher inflation followed by higher unemployment. We have just escaped from the highest rate of inflation this country has known; we have not yet escaped from the consequences: high unemployment.¹⁴³

This has often been taken as evidence that Labour had abandoned full employment as a goal of policy, endorsed monetarism and repudiated the post-war consensus.¹⁴⁴ However this overstates the extent to which the IMF crisis marked a change in policy. As Steve Ludlam has noted, the change in policy had begun in 1975.¹⁴⁵ Burk & Cairncross consider it a ruse to impress market opinion, but not one that translated into any policy that would lead to cuts and further unemployment.¹⁴⁶ Jim Tomlinson agrees, noting:

¹⁴² Wass *Decline to Fall* p229

¹⁴³ Quoted in Hickson *The IMF Crisis of 1976* p103

¹⁴⁴ Anthony Seldon, "Ideas Are Not Enough" in David Marquand and Anthony Seldon [eds.] *The Ideas That Shaped Postwar Britain* (London: Fortana, 1996) p260; David Smith *The Rise and Fall of Monetarism* (London: Penguin, 1987) p65; Harmon *The British Labour Government and the 1976 IMF Crisis* p164

¹⁴⁵ Steve Ludlam, "The Gnomes of Washington: Four Myths of the 1976 IMF Crisis" p727

¹⁴⁶ Burk & Cairncross *Goodbye Great Britain* p148

[A]s a description on post war economic events it was largely nonsense; full employment in the 1950s and 1960s had not been maintained at the price of ‘higher and higher’ inflation.¹⁴⁷

Instead the speech recognised the need to placate market opinion to secure survival of a Labour government. Earlier in his speech Callaghan recognised the cause of unemployment as “paying ourselves more than the value we produce,” and indeed most of his speech dealt with how to overcome unemployment.¹⁴⁸ This was a theme reinforced by Healey’s speech who shot down criticism from the left who favoured Benn’s AES, arguing it would bring the Tories to power and mass unemployment. Healey claimed, “if you do not want these alternatives, then we have got to stick to the policy we have got.”¹⁴⁹ Healey and Callaghan were therefore able to facedown criticism from the left in favour of an AES by positioning recourse to the Fund as the means of preserving a Labour government.

6.8: What Crisis? The Sterling Balances and IMF Bailout October 1976 – November 1976

While committing to a programme of reduction in government borrowing and greater control of credit, Callaghan’s objective for resolution of the crisis was wider than securing agreement with the IMF. This stemmed from his analysis that the fundamental cause of the crisis was sterling’s continued reserve role and the danger posed by diversification from the small number of oil producers which now accounted for the majority of official balances. Callahan did not interpret the crisis as primarily resulting from his government’s current economic policy, which following previous rounds of expenditure cuts, was now deemed appropriate. However it should be remembered that the continued existence of these balances was, in part, the result of previous attempts to negotiate the external constraint, notably the terms of the 1968 Basle deal aimed at preserving Bretton Woods, as well as the use of oil producers’ deposits to defer adjustment to the OPEC shock.

¹⁴⁷Jim Tomlinson “Economic Policy” in Roderick Floud and Paul Johnson [eds.] *Cambridge Economic History of Modern Britain Vol. 3 Structural Change and Growth* (Cambridge: Cambridge University Press, 2004) p201

¹⁴⁸ Quoted in Hickson *The IMF Crisis of 1976* p102

¹⁴⁹ Healey *The Time of My Life* p429

Nevertheless, Callaghan now used his commitment to agreeing terms with the IMF as leverage to secure international commitment for a wider support package aimed at finally resolving sterling's reserve role given the failure of previous rounds of reform to do so.

In economic diplomacy therefore, Callaghan's first objective was in his *narration* of the crisis, to demonstrate it resulted from sterling's reserve role. He looked for a quick deal with the IMF based on Britain's existing policies but believed a separate deal on the sterling balances would be required to definitively settle the issue. Conversely, an IMF deal without a separate facility would not stabilise sterling or allow that Labour government to continue in office, given the level of expenditure cuts that would then be required. In a letter to Ford expressing his gratitude at the President's agreement in expediting the British discussions with the Fund, Callaghan defended his government's existing policies, arguing inflation and government spending were on a downward trajectory and called for a "contingent loan facility" linked to the balances, without which stability could not be restored. If such a facility was not forthcoming, Callaghan called into question the British contribution "as an ally and a partner in the Western Alliance and its value as a member of the International Trading Community."¹⁵⁰ On 25 October Callaghan appeared on *Panorama* to call publicly for an end to the sterling balances:

I would love to get rid of the reserve currency...I am not sure that everybody in the Treasury would, or maybe in the Bank. But from Britain's point of view I see no particular advantage in being a reserve currency at all.¹⁵¹

As we have seen, this was somewhat misleading given the extensive use of sterling's international role his government had made since 1974 in delaying adjustment. This attempt to narrate the crisis as an issue of the sterling balances ran into opposition in Washington. To the Ford administration, the crisis resulted from Labour's pandering to the unions in formulating economic policy and lack of

¹⁵⁰ FRUS 69-76 Vol. E-15 Part 2 Documents on Western Europe 1973-1976 "Memorandum From the President's Assistant For National Security Affairs (Scowcroft) to President Ford" Undated

¹⁵¹ Burk & Cairncross *Goodbye Great Britain* p67 - 68

resolute action on inflation. Markets had also been unsettled by calls from within the Labour party for nationalisation of the banks and insurance companies.¹⁵² As Yeo had noted to Ford in June, some form of additional support for sterling was not beyond the means of the US but argued it would mean fresh unconditional credit for the United Kingdom. Any indication that the US was prepared to consider the idea would support those on the left of the Labour party who did not appreciate gravity of the situation.¹⁵³

At the heart of the conflict was disagreement over what would shift market sentiment in a positive direction. While Callaghan looked for international endorsement of the government's policies based on agreement with the IMF and a separate facility for sterling, the Americans advocated a change in the policies themselves. Sterling remained under pressure in October, dropping to \$1.65 on 3 October, its lowest level yet. In a meeting with Yeo, Healey was advised to undertake a bear squeeze on creditors, with the MLR raised to 15% on 7 October. "Greed will overcome fear," Yeo had advised the Chancellor, but the Treasury was not taken in by his arguments, believing sterling holders were not much influenced by marginal changes in interest rates.¹⁵⁴ Although the exchange rate stabilised following the increase of MLR, a report in the Sunday Times on 24 October which stated the IMF expected a depreciation to \$1.50 resulted in a fresh bout of selling. The same day Milton Friedman appeared on American television to offer the opinion that Britain was on the verge of collapse.¹⁵⁵

At the IMF meeting in Manila, Burns expressed criticism of Labour's economic policies, arguing the current crisis was the result of failing to take more decisive action earlier in the year.¹⁵⁶ The US plan was indeed to leverage the role of IMF conditionality to secure a fundamental shift in British policy. Kissinger had made this point to Yeo in June, noting:

¹⁵² FRUS 69-76 Vol. E-15 Part 2 "Memorandum From the President's Assistant For National Security Affairs (Scowcroft) to President Ford" Undated

¹⁵³ FRUS 69-76 Vol.31 "Memorandum from Under Secretary of the Treasury for Monetary Affairs (Yeo) to President Ford" 16 June 1976

¹⁵⁴ *Wass Ibid* p349

¹⁵⁵ *Cappie Bank of England* p751

¹⁵⁶ *Ibid* p231

if the British are smart, it could be in their interest to be pressured into agreement on conditions, so that they can say that the only reason they imposed stringent conditions on the British economy is because of those American SOB's. This is better for Callaghan than having to deal with the unions himself.¹⁵⁷

This line of reasoning has been developed by Rogers, arguing that the imposition of IMF conditionality allowed Callaghan to shore up his domestic support, depoliticising the consequences of policies to stabilise sterling by presenting them as lacking an alternative.¹⁵⁸ This is however only one side of the story. Callaghan's preferences extended beyond domestic policy and into the realm of economic diplomacy, namely resolving the issue of the sterling balances. Analysing the simultaneous attempts to secure international support for an additional sterling facility allows us to put the IMF negotiations in a wider context, demonstrating the outcome of the crisis to be more significant than reduction in public spending levels.

6.9: Solutions to the Sterling Balances – June 1976 – November 1976

While Callaghan was in favour of doing something about the balances, there was not at this stage clarity on what exactly could be done. The experience of the previous ten years had outlined various proposals for resolving the issue of national currencies in reserves, both as general reform to the international monetary system and as part of schemes tailored specifically to sterling. The Treasury was therefore able to draw on these to quickly detail options for resolving sterling's international status, while also drawing appropriate lessons from the successes and failures of previous attempts.

According to a paper by Douglas Walker of the Treasury, there were several options. Funding would involve some form of maturity transformation, in which the short-term liabilities were replaced with long term, less liquid ones. On the other hand, substitution would see sterling be replaced by claims on the international community, while the British would assume an obligation to the IMF to

¹⁵⁷ FRUS 69-76 Vol. 31 "Memorandum of a Conversation" 4 June 1976

¹⁵⁸ Rogers "The Politics of Economic Policy-Making under Harold Wilson and James Callaghan and the 1976 IMF Crisis" p247

amortise the liability. Finally, the United Kingdom could finance switching out of the currency by drawing on a medium-term loan set up for the purpose – which was the precedent of 1968 Basle deal. Any operation would have a cost for Britain, either in the maintenance of new obligations arising from any funding or substitution operation or in the exchange rate element in taking on medium term borrowing to finance switching out of sterling.¹⁵⁹

Substitution had been the objective of the previous Labour government whereby the problem of sterling would be resolved via a general reform of the role of reserve currencies in the international monetary system. As Walker's paper noted, reform efforts had stalled in response to disagreements over the dollar overhang and the policy of benign neglect regarding the dollar. As well as setting a significant precedent in the international community assuming the obligations of an individual country, it would also likely be mandatory, provoking pre-emptive switching in the event of any negotiations around the prospect, destabilising sterling and making a Basle style facility necessary at the outset of any such negotiations. While such a facility could therefore stand on its own, it would be a necessary preliminary condition for any wider substitution discussions.¹⁶⁰

Circulation of Walker's paper around the Treasury and the Bank revealed scepticism over the prospects for support. Ryrie was pessimistic about the chances of receiving substantial support for sterling without additional onerous conditions. He was sceptical about Walker's ideas for substitution via the Fund, as he did not think there was enough concern about the sterling balances to warrant such a radical precedent. There was no longer a general fear about a collapse of sterling undermining global trade and payments. Nor in a dollar world was there much concern about dollar overhang given that dollar convertibility had already ended. Ryrie concluded the proposal for financing switching through a medium-term loan was the more likely option, but warned that any such deal would be acceptable only on its terms, not for the sake of it.¹⁶¹ The Bank, traditionally

¹⁵⁹ T381/5 "Funding Sterling Balances" 14 May 1976

¹⁶⁰ T381/5 "Funding Sterling Balances" 14 May 1976

¹⁶¹ T381/5 "Letter from W S Ryrie to Sir Derek Mitchell" 28 May 1976

more in favour of the reserve role of sterling, was also critical of Walker's paper. Like the Americans, the Bank believed that any support of sterling would prove short lived if not accompanied by more fundamental measures to improve confidence. Like Ryrie, the Bank considered the safety net facility the more likely option, but Walker was concerned the Bank favoured a facility that would never be drawn.¹⁶² In any case the Bank correctly expected there would be no movement on the balances from Germany and the US until the British had drawn all its resources from the IMF and had been subjected to Fund conditionality. The Bank also warned against accepting any facility for the sake of it and made a defence of the balances, in effect making the same argument as the Americans were to do:

Sterling balances can be tiresome; they involve higher interest rate payments than debt in most other currencies; but if we can manage our economy even tolerably well, they have the great charm of not necessarily having to be repaid.¹⁶³

Walker was not convinced by this argument. The massive external balance sheet of the United Kingdom and its substantial dependence on the current account meant Britain would find it difficult to accept an exchange rate wholly determined by the market, even if the policies deemed 'appropriate' were being pursued. Sterling was particularly prone to "bandwagon" effects – what would become known as overshooting – due to the existence and liquidity of the balances. The case could be made that even after drawing on Britain's 4th credit tranche at IMF – involving the Fund's approval of domestic policies – this would not be enough to assure stability due to the danger from diversification.¹⁶⁴

Work had advanced sufficiently by the end of August for the Treasury and Bank to submit a joint paper to the Chancellor, who forwarded it with his approval to the Prime Minister. The paper was concerned that the \$3.8bn available from the IMF would be a first step towards solvency but might

¹⁶² TNA T381/6 "Walker to Payton (BoE)" 11 August 1976

¹⁶³ TNA T381/5 "Coping with the Sterling Balances" 2 June 1976

¹⁶⁴ TNA T381/5 "External Financing and the Sterling Balances" 28 July 1976

not be enough to see sterling through the projected deficits of 1976 and 1977, making further support necessary. The paper listed arguments against an IMF substitution account, noting it would lead to debates over the role of reserve currencies in general, involve protracted negotiations via the IMF and could prompt mass diversification out of sterling as holders sought to get out before they were forced to take on SDRs. It was believed that the safety net would be easier to organise since it would draw on the precedent of 1968, although the paper conceded that other countries could not be expected to be enthusiastic about the idea.¹⁶⁵ Although using the 1968 Second Group Arrangement as a precedent it was recognised that developments in the global economy since then meant fundamental changes would be required. Exchange guarantees were considered unsuitable in a floating world, while the concentration of the balances in a small number of oil producing states for whom sterling constituted a minority of their reserves meant participating countries were less likely to commit themselves to MSP ratios.¹⁶⁶ The 1968 deal had been associated with a build-up of sterling balances rather than a run down. As Walker noted, countries lending the money would want to avoid an open-end commitment and would look to sterling guarantees and MSPs as tools that would minimise the possibility of any drawing. On the other hand, Walker believed the British interest was that any such facility was not merely a safety net, but one that was drawn upon to finance a sizable net reduction in the balances.¹⁶⁷

A key issue for the government was conditionality. Both the Treasury and the Bank warned against being bounced into accepting any scheme just for the sake of it, although the danger was that once negotiations had been made public the reaction of markets to the disappointment of no scheme being arranged could seriously threaten sterling. It was hoped that conditionality for the facility would be along the lines of the general IMF conditions of economic management. Agreeing with the paper's conclusions, Healey cautioned the Prime Minister that new facility was no substitute for IMF

¹⁶⁵ TNA T381/6 "A Safety Net" 31 August 1976

¹⁶⁶ TNA T381/6 "Safety Net and Sterling Guarantees 11 August 1976

¹⁶⁷ TNA T381/6 T381/6 "A Safety Net Work in Progress" 11 August 1976

drawing and in any case would not be forthcoming prior to the settlement of the standby, since they would be drawing the required funds from the same group of creditors.¹⁶⁸

Much would depend on the attitude of the Americans. Simon and Yeo had already made their opinions known, Yeo advising Healey on 3 August that the balances would be an advantage once the British economy turned the corner and that an additional safety net would involve heavy political costs and would tie up funds needed elsewhere.¹⁶⁹ This opposition had made some in the Treasury consider whether it was worth the political capital.¹⁷⁰ Nevertheless, Callaghan looked to circumvent them by appealing directly to Ford, positioning a facility as part of package with any IMF deal that would decisively end the problem of the sterling balances.¹⁷¹ As he explained to Healey, "we must keep up the momentum gained, and I do not think we should be inhibited in doing so by the timing of elections in the United States." At this stage, Callaghan was thinking of a \$5bn safety net, speculating further that \$10bn or even more would constitute a decisive breakthrough while not ruling out substitution through the IMF at some point. Callaghan's main leverage was the threat to the British contribution to trade and defence.¹⁷² For his part Healey was more cautious, critical of reports in the press which he saw emanating from "Mt. Lever" about the needs for massive loans for Britain beyond which the IMF could provide. As he noted to the Governor of the Bank of England, when the subject of the safety net had been raised with Ford, the President had been non-committal.¹⁷³

The initial American response was not positive. At his meeting with Healey on 3 October, Yeo talked down the prospects of a facility for sterling, claiming he saw no prospect of massive additional help for the currency. If any support was to be made available it would be dependent on policies such as monetary restraint and cutting public expenditure which, he believed, would solve the so-called

¹⁶⁸ TNA T381/6 "A Safety Net" 31 August 1976

¹⁶⁹ TNA T381/6 "Note for the Record" 3 August 1976

¹⁷⁰ TNA T381/6 "Letter from W.S Ryrie to F R Barratt" 10 August 1976

¹⁷¹ TNA T381/6 "Speaking Notes for the PM" 29 September 1976

¹⁷² TNA T381/6 "Memo from Callaghan to Healey" 30 September 1976

¹⁷³ TNA T381/6 "Note for the Record" 30 September 1976

problem on their own. Despite Healey reiterating his belief that the facility would not likely cost its contributors anything, Yeo advised the Chancellor not to raise the facility at the current time, arguing that the markets would not be impressed by the admission that even the IMF standby was not enough to solve British problems.¹⁷⁴ Meanwhile in Manila, Simon forwarded on to Ford the results of conversations he and Burns had been having with British officials. Simon advised the President not to give any indication of support to the British beyond the IMF standby to maintain the principle that countries with balance of payments difficulties should resort to the IMF alone.¹⁷⁵

There was also an attempt to solicit German support. Assuming the IMF drawing was approved, the British looked for German backing on securing the overall size of the standby, including the initial drawing and support for a safety net facility to be negotiated at the same time.¹⁷⁶ A visit by Helmut Schmidt, who had become West German Chancellor in 1974, to Chequers at the beginning of October was kept off the record, but as a colleague noted in a letter to Derek Mitchell of the Treasury, "one can be pretty sure that if Schmidt saluted when the PM ran the safety net up the flagpole, we should have heard all about it immediately."¹⁷⁷ A call between Pohl and Mitchell revealed Schmidt had returned from Chequers "depressed and pessimistic" and advised that while the Germans would give what support they could, there had to be a political dimension, including first settling terms with the IMF.¹⁷⁸ Following Callaghan's appearance on *Panorama*, Pohl complained to Mitchell had once again raised the issue without clarifying his ideas on the subject. Mitchell, who was still in the dark regarding the discussions between Schmidt and Callaghan, conceded the he too was unclear as to what the PM had in mind, but ruled out sterling guarantees and talked in terms of a medium-term facility as the most attractive option to sterling holders. Pohl considered such a

¹⁷⁴ TNA T381/6 "Note of a Discussion" 3 October 1976

¹⁷⁵ FRUS 69-76 Vol. E-15 Part 2 Memorandum From the President's Assistant for National Security Affairs (Scowcroft) to President Ford" 3 October 1976

¹⁷⁶ TNA T381/6 "Visit of Herr Schmidt: Steering Brief on External Financing Questions: IMF Drawing and Safety Net" 07 October 1976

¹⁷⁷ TNA T381/7 "Sterling Balances" 07 October 1976

¹⁷⁸ TNA T381/7 "Conversation with Karl Otto Pohl" 18 October 1986

“liquidity guarantee” possible but not without the US and promised to raise the issue with Yeo in forthcoming talks.¹⁷⁹

With the Americans and Germans non-committal at best, the Treasury considered what actions could be taken unilaterally by the British to solve the sterling balance problem. A proposal drawn up by the Treasury for an SDR bond whereby sterling holders would be offered a transformation of their liability from short term to long term was overruled by the Chancellor on the advice of the Bank on the basis that it would be an implicit admission of weakness. This argument was criticised by the Treasury noting that knowledge of sterling’s weakness was already widespread and that an SDR bond would offer Britain the means of taking the offensive, offering sterling holders another option beyond diversification into another currency. The scheme could operate in tandem with the safety net and would reassure creditors the facility would not be drawn upon.¹⁸⁰ Alternatively a scheme involving \$5bn - \$10bn bond issued through the BIS would have the advantage of leaving Basle to negotiate with creditors.¹⁸¹ In response, Healey advised Callaghan he was against the SDR scheme on its own, fearing it would imply the United Kingdom was only worth investing in when denominated in a non-sterling currency, but felt that, in tandem with safety net proposals it would prove a welcome contribution towards stability in exchange markets.¹⁸²

Britain’s strategy continued to develop in the week before the arrival of the IMF mission. A meeting held on 1 November between Callaghan, Healey, and Lever, with Wass and Mitchell representing the Treasury, discussed the options open to sterling. Prior to the meeting Wass advised the Chancellor that the question of additional support was likely to take up the bulk of discussion. Callaghan wanted agreement on the safety net thrashed out before signing up to any IMF arrangement. Wass argued this implied “immense problems,” given the reluctance of Simon, Yeo and Congress to put forward

¹⁷⁹ TNA T381/7 "Note for the Record" 27 October 1976

¹⁸⁰ TNA T381/7 "Sterling Balances: An SDR Bond" 21 October 1976

¹⁸¹ TNA T381/7 "Safety Net and BIS Bond Scheme" 22 October 1976

¹⁸² TNA T381/7 "An SDR (OR Dollar) Bond and the Safety Net" 29 October 1976

any funds outside of the IMF agreement.¹⁸³ Reporting back on Pohl's discussions with Yeo, Mitchell informed the group that Yeo had taken a hard line with regards to sterling, apparently demanding Britain repay in full all withdrawals from the swap agreement credit by the 9 December deadline. No further support would be forthcoming prior to settlement with the IMF. Pohl himself had been more positive, claiming the Germans were in favour of a safety net but this would depend ultimately on the approval of the Americans. He recommended the British "downplay" the proposal prior to the IMF settlement, on which he advised accepting at least the "impression" of conditionality.¹⁸⁴

Despite the obvious American reluctance to concede a limited safety net, Lever believed even more support could be secured. That same day he had forwarded Healey a detailed proposal of a so-called "masse de manoeuvre," whereby swap arrangements would be arranged with the Fed in the order of \$3bn - \$5bn, in addition to \$2bn lines arranged with the Japanese and Germans. Although the swap lines would nominally be short term, Lever believed the overall facility would effectively be long term, since one swap could be paid off by drawing upon another.¹⁸⁵

Prior to the meeting, Wass acknowledged the attraction of having enough funds at the government's disposal to corner the exchange market and pursue any strategy the government wished, but diplomatically concluded that it would be extremely difficult to negotiate on the basis of a minimal change in policy.¹⁸⁶ Commenting later in the month, Walker was much more scathing, arguing it would be

sanguine to the point of total unrealism to suppose that we might be able to bring off Mr Lever's suggested multiple swap facility in addition to both the IMF standby and a safety net.¹⁸⁷

¹⁸³ TNA T381/7 "Memo from Wass to Healey" 01 November 1976

¹⁸⁴ TNA T381/7 "The IMF Loan and Safety Net for Sterling Balances" 01 November 1976

¹⁸⁵ TNA T381/7 "Memo from Lever to Healey" 01 November 1976

¹⁸⁶ TNA T381/7 "Memo from Wass to Healey" 01 November 1976

¹⁸⁷ TNA T381/7 "Beyond the IMF and the Safety Net" 12 November 1976

The mere suggestion that both the IMF drawing and the safety net would still not be enough to solve sterling's problems would confirm creditors in their worst views of the government's economic strategy.¹⁸⁸ At the meeting itself however, Healey seemed inclined to give Lever's proposals a hearing. His stated objective for the crisis was securing international assistance in three separate operations; an IMF loan to stabilise the exchange rate and finance the deficit; a safety net facility to stabilise the sterling balances; a further long-term loan. However, he recommended that IMF negotiations be completed as soon as possible to begin work on what further support would be available.¹⁸⁹ This however would require some revision to the government's spending plans. As Wass noted, on present policies the United Kingdom was faced with a very high PSBR in 1977 and an excessive growth in money supply, undermining confidence in sterling. On the other hand, the prospect of North Sea oil coming on stream within the next two years argued against 'overkill.' Wass claimed that it was in Britain's interests to moderate government spending, even if creditors permitted the government to make no change in policy (an unlikely prospect). However, given the weak state of domestic demand and prospect of external balance by 1978 the adjustment should be a small one, in the region of £1bn change in fiscal demand.¹⁹⁰

The build-up to the IMF mission therefore demonstrated the extent to which an IMF deal was considered only part of the solution by Callaghan. As Healey noted to a meeting of the EY committee on 3 November, projections for economic fundamentals such as unemployment, inflation and living standards were not favourable, requiring extensive international support to stabilise sterling. "We must get the IMF borrowing for 1977 and fund the sterling balances if we can."¹⁹¹

¹⁸⁸ TNA T381/7 "Beyond the IMF and the Safety Net" 12 November 1976

¹⁸⁹ TNA T381/7 "The IMF Loan and Safety Net for Sterling Balances" 01 November 1976

¹⁹⁰ TNA T381/7 Memo from Lever to Healey" 01 November 1976

¹⁹¹ Burk & Cairncross *Goodbye Great Britain* p71

6.10 The IMF Mission November 1976 – December 1976

Following the arrival of the IMF mission, the respective IMF and Treasury teams met formally for the first time on 4 November. Wass informed the Treasury's Policy Coordinating Committee [PCC] that in negotiation with the Fund, "on no account should officials express any view, except on his specific authority, about what policy changes were desirable." Despite a PSBR figure for 77/78 of £11.2bn being leaked to the press on 6 November, the British team opened negotiations on the basis of existing policies.¹⁹² The scale of the disagreement between the British and the Fund was revealed at a meeting on 10 November when Alan Whittome, the IMF lead representative, called for a PSBR in 77/78 of no more than £7bn. Meeting Healey the next day he was told by the Chancellor that a reduction in the region of £3-£5bn was "not on."¹⁹³ Disagreement in Cabinet over a public expenditure white paper centred over whether the government should propose its own cuts or wait for the Fund to do so.¹⁹⁴ Whittome returned to Washington on 12 November with little progress to show as a result of Healey's refusal to allow discussion on policy changes.¹⁹⁵

While stonewalling the IMF, much greater effort had gone into engaging the international community regarding a separate sterling facility. Prospects for such a facility took a brighter turn on 3 November when Schmidt called Callaghan to tell him, in "suitably guarded language" that after speaking to Ford he had discerned a genuine will in the White House to be helpful towards Britain, notwithstanding opposition in the Treasury and Congress.¹⁹⁶ The British attempted to kick off discussions on a safety net at the BIS although resistance from Burns was anticipated whether dealing bilaterally with the Americans or via the BIS.¹⁹⁷ At a meeting of Central Bank governors in Basle on 8 November Richardson attempted to secure agreement for the BIS to set up a working

¹⁹² Chris Rogers *The IMF and European Economies Crisis and Conditionality* (Basingstoke: Palgrave Macmillan, 2012) p134

¹⁹³ Wass, *Decline to Fall*, p263

¹⁹⁴ Burk & Cairncross *Goodbye Great Britain* p75

¹⁹⁵ Wass *Decline to Fall* p264

¹⁹⁶ TNA T381/7 "Prime Ministers Talk with Chancellor Schmidt" 03 November 1976

¹⁹⁷ TNA T381/7 "Note for the Record" 03 November 1976

party to examine the technical details. The opinion of the Germans and Americans would be key and prior to the meeting Healey talked with Pohl to discuss his major concerns for the British economy. As the Chancellor summarised the situation, a collapsing exchange rate from sterling holders' diversification risked fuelling inflation and growth in the PSBR. The IMF arrangement would help stabilise sterling but there was a danger it would not be enough. Healey also warned that the demands of the IMF might be too much for some of his cabinet colleagues who were flirting with the idea of a siege economy. While conceding that there was no chance of activating a safety net prior to the IMF negotiations, Healey sought Pohl's support for beginning technical discussions so progress could be made quickly once the IMF standby was agreed.¹⁹⁸

The response was not promising. In his discussion with Healey, Pohl seemed uninterested in the arguments for a sterling balance facility, advising instead the British would better off pursuing policies that attracted capital and warned that the German delegate Klasen agreed with Yeo in his perception of the crisis.¹⁹⁹ At Basle, while most of the delegates found Richardson's argument that a safety net would complement an IMF standby in stabilising the exchange rate reasonable, the Americans were adamant that technical discussions should not even begin until after the IMF standby had been agreed and gave no indication as to whether they would participate even at that point. As a result, no working party was established although the BIS agreed to do bilateral work on the subject with the Bank of England.²⁰⁰

Callaghan now appealed directly to Ford, sending Lever to Washington as his personal envoy. In his letter informing the President, Callaghan took the opportunity to defend his government's record noting the July decision to reduce the PSBR in 1977 by £2bn, despite domestic political opposition. A lacklustre world economy had frustrated Labour's export led growth strategy and compounded the problem of the sterling balances. "We find ourselves running hard to stay in the same place,"

¹⁹⁸ TNA T381/7 "Note on a Conversation with Herr Pohl at 11.45AM in Brussels" 09 November 1976

¹⁹⁹ *Ibid.*

²⁰⁰ TNA T381/7 "Note of a meeting held at 11 Downing Street at about 7.45pm" 09 November 1976

Callaghan noted and while conceding the potential for further action on government spending, ruled out the calls for “massive deflation” he saw emanating from the IMF. Such policies would be catastrophic, not just for the Labour government but in a wider sense, leading to Britain being unable to fulfil its global commitments and resorting to extreme left or right-wing solutions.²⁰¹

In response to Callaghan’s letter, Simon personally lobbied Ford on standing firm against what he saw as British attempts to circumvent IMF conditionality. According to Simon, the British proposals at Basle demonstrated their belief that the sterling balances rather than Labour’s excessive policies were the cause of the crisis and a “funding” operation via a large international credit would help rectify the situation. This was perhaps not a deliberate misrepresentation of British ideas, since Simon admitted the definition of funding was an elusive one that the British had failed to clarify. Simon noted that Britain had so far drawn extensively from international sources of credit, including \$2bn from the Fund earlier in the year, the \$3.9bn standby being negotiated, drawings on swap networks and reserves as well as an estimated \$3.5bn on private capital markets. If the British could expect to be continually bailed out from the consequences of their poor decisions, countries like Italy, Mexico and Brazil would want the same.²⁰²

Lever met Ford on 16 November, accompanied by the British Ambassador Ramsbotham and Ryrie who represented the Treasury. Aware of Simon’s position, Lever was at pains to stress the Labour government’s pragmatic approach to economic management, claiming the British economy had undergone a “remarkable” transformation since the July measures. His main concern was that not everyone in the US appreciated the extent of change in British policy or the risk to Britain’s commitment to free trade and her global role from the continuing instability. Lever warned that demands for excessive cuts from the IMF would create domestic unrest if pushed through against high unemployment. Action on the sterling balances was also required since the decline in sterling

²⁰¹ FRUS 69-76 Vol. E-15 Part 2 “Letter From British Prime Minister Callaghan to President Ford” 12 November 1976

²⁰² FRUS 69-76 Vol. E-15 Part 2 “Memorandum From Secretary of the Treasury Simon to President Ford” 15 November 1976

was unjustified given the government's policies and prospect of North Sea oil balancing the external account by 1978. Ford was sympathetic, if non-committal during this first meeting.²⁰³

The next day Lever delivered a note from Callaghan stressing it was "essential" that the finalisation of the IMF loan and agreement on a facility for sterling were announced simultaneously. Callaghan wanted agreement that after the IMF drawing was finalised, the Fed would participate in the BIS initiative on a sterling safety net.²⁰⁴ Ford's senior advisers were unenthusiastic to say the least. Simon evaded giving any firm commitment to the safety net, Kissinger confused the proposal with his moribund OECD fund while Burns flatly refused to even consider the idea prior to successful agreement with the IMF.²⁰⁵ Despite this, Ford sent Callaghan a letter shortly after Lever's visit claiming that once the IMF negotiation had been successfully completed the US would work sympathetically on a solution to the problem of the sterling balances. Overruling the objections of the Treasury and Burns, Ford agreed that a safety net operation could be announced simultaneously with the IMF drawing.²⁰⁶ Thus while Callaghan was disappointed by the timing of the relative IMF and BIS support arrangements, this was an acceptable compromise to ensure American commitment.

The prospect of American support for a deal on the sterling balances provided impetus to come to agreement with the Fund. While Lever was meeting with Ford, Whittome, who had returned to London the previous day, sat down with Callaghan and Healey. With a PSBR of £10.5bn expected on 77/78, action was required on public expenditure while the monetary aggregates also needed to come down.²⁰⁷ A briefing for a meeting of the EY committee on 17 November noted that ministers understood agreement with the Fund was necessary as support for sterling was urgently needed.

²⁰³ FRUS 69-76 Vol. E-15 Part 2 "Memorandum of a Conversation" 16 November 1976

²⁰⁴ FRUS 69-76 Vol. E-15 Part 2 "Note From the Government of the United Kingdom to the White House" 17 November 1976

²⁰⁵ TNA T381/8 "The United States and a Sterling Safety Net 18 November 1976

²⁰⁶ TNA T381/8 Telegram from Ford to Callaghan 20 Nov 1976; FRUS 69-76 Vol. E-15 Part 2 "Memorandum From the President's Assistant for National Security Affairs (Scowcroft) to President Ford" 21 November 1976

²⁰⁷ TNA PREM 16/801 "IMF Negotiations" 17 November 1976

However, given the forecast of 2 million unemployed by mid-1978, even on a PSBR of £11bn it was in Britain's interest to get "economically rational and politically acceptable terms." As such, any deal with the IMF should be based on a package with a minimum impact on employment. Raising £700m from selling BP shares and cutting export credits was floated but it was noted that this might be "too little blood" for the IMF. Ideally this would be combined with savings of £300m from a public-sector recruitment moratorium, £2-300m savings on defence while softening the blow with an extra £200m extra investment. If forced into a big package, £2-3bn of savings could be found by also increasing £1bn in taxes combined with £1bn in cuts from social security.²⁰⁸ The meeting concluded with authorising the Treasury to discuss with the Fund the implications of cutting the 77/78 PSBR to £10bn, £9.5bn or £9bn but without committing ministers to any such deal.²⁰⁹

Full discussions took place between the Fund and the Treasury on 18 and 19 November. On 18th, Wass informed Whittome that while he could not commit the government he believed it would be possible to secure a PSBR of £9.5-10bn. Whittome was "visibly astonished at this" and said the gap now looked unbridgeable, to which Wass suggested he sleep on it.²¹⁰ At a meeting with Healey the following day, Whittome said he wanted a 78/79 PSBR of £6.5bn as a focal point from which he implied a 77/78 PSBR of £8.5bn. Healey responded that he had no authority to negotiate on the basis of a PSBR lower than £9bn for 78/79.²¹¹ In response to the meeting the Fund communicated a memo in which they outlined their assumptions for the British economy. The starting point was a DCE expansion of £5bn in 78/79 which was consistent with a PSBR of £6.5bn and assumed 4% growth in GDP. Working backwards, the figures in 77/78 would involve DCE expansion of £6.7bn with a PSBR of £7.5bn and growth of 1.5%. The cuts were therefore assumed to be deflationary in the first year but followed by strong growth in exports and investment the subsequent year. The

²⁰⁸ TNA PREM 16/801 "'EY Committee: IMF Negotiations" n.d

²⁰⁹ Wass *Decline to Fall* p267

²¹⁰ TNA PREM 16/801 "Principal Private Secretary" 18 November 76

²¹¹ TNA PREM 16/802 "Note of a Meeting Held at No 11 Downing Street at about 7pm on Friday 19 November 1976" 19 November 1976

Treasury were not impressed by this approach (which was based on assuming a high rate of GDP growth resulting from improved confidence and lower interest rates). In response, the cabinet approved the Treasury to put forward its own proposals on the size of PSBR and DCE.²¹²

A meeting of the Cabinet on the 23 November witnessed a showdown between ministers over the IMF negotiations. A left-wing group of ministers including Foot, Benn and Shore made the case for resistance to the IMF. In reply Healey argued for a PSBR of £9bn in 77/78 based on £1bn in cuts and £500m sales from BP shares. Crosland objected that there was no case for further deflation given the level of unemployment and called into question the Treasury's forecast. Crosland advised threatening the IMF, Germans and Americans with a siege economy, concluding "our weakness is our strength...it is a test of nerve and IMF must give us the loan."²¹³ Meeting Whittome later that day, Callaghan informed him that the Cabinet would not agree to a lower PSBR than £9.5bn for 77/78. Callaghan argued the PSBR acted like a "talisman" in negotiations. Too small a reduction and the markets would not be convinced, too much and the Social Contract between the government and the unions would collapse. In response Whittome argued that a £9.5bn PSBR would not convince the "millions of bankers all over the world" whose response would determine the fate of sterling.²¹⁴

At the same time Callaghan looked to engage Ford and Schmidt to lobby the IMF. Noting the Cabinet's refusal to go below £9.5bn, Callaghan argued there were extensive political and economic reasons not for agreeing to more stringent cuts. Unemployment was higher than at any time since the 1930s and forecast to rise higher on the basis of existing policies, let alone further public expenditure cuts. While in deficit, the balance of payments was projected to be in surplus by 1978. The extent of the cuts demanded by the IMF would undermine the relationship with the unions and would precipitate a fall in the government. Callaghan urged both to intervene with the Fund's

²¹² *Wass Decline to Fall* pp.273-274

²¹³ Quoted in Burk & Cairncross *Goodbye Great Britain* p87

²¹⁴ TNA PREM 16/802 "Note of a Meeting" 23 November 1976

Managing Director to “impress on him the need to moderate their terms to what can be made politically acceptable in this country.”²¹⁵

Ford however would not be drawn to leverage American influence on the IMF negotiations. As he agreed with Schmidt, strong conditions needed to be imposed on the British, although perhaps moderated to keep the Labour government in office. The President believed Callaghan could go further than £9.5bn, although not as far as £9bn, indicating his assessment of the situation was closer to Callaghan’s than the Fund’s.²¹⁶ Replying to Callaghan on the 24 November Ford explained it would be “inappropriate” for America to interfere with the Fund negotiations, but assured the Prime Minister once more that the US would move “sympathetically” on the sterling balances once agreement was reached on the IMF standby.²¹⁷ In his own response Schmidt noted he could hardly persuade Witteveen of the necessity of Callaghan’s economic arguments if he was not convinced by them himself.²¹⁸

With the international context hardening against the British, the Treasury proposed its own series of 3 alternative packages to the Fund on 24 September, each including £0.5bn sales of BP Shares. The only package which raised any interest from the Fund, was the third, heaviest one which proposed cuts of £1.5bn in 77/78 and £2bn in 78/79 leading to PSBR of £8.5bn in 77/78 followed by a slightly smaller one the following year. DCE was accordingly given at £7.5bn for both years. The most disturbing outcome of the meeting was how far apart the Treasury and the Fund were on the PSBR for 78/79, even based on a reduction in public expenditure that was resisted by a majority in the Cabinet. At the heart of the disagreement was the Fund’s much more optimistic assessment that cuts would have on the economy, boosting investment through improved confidence which, together with higher exports, would increase tax receipts and hence lower government borrowing.

²¹⁵ FRUS 69-76 Vol. E-15 Part 2 “Message From British Prime Minister Callaghan to President Ford” 23 November 1976; TNA PREM 16/802 “Letter from PM to Schmidt” 23 November 1976

²¹⁶ FRUS 69-76 Vol. E-15 Part 2 “Memorandum of a Conversation” 24 November 1976

²¹⁷ TNA PREM 16/802 “Letter from Ford to Callaghan” 24 November 1976

²¹⁸ TNA PREM 16/802 “Tel No 1093” 24 November 1976

Due to the inherently uncertainty of the projections, Wass advised against making commitments to the PSBR and DCE for two years.²¹⁹ A proposal made by Wass and taken up by Healey suggested making targets for 78/79 dependent on economic growth projected by the Fund. According to Wass's later record, this proved a breakthrough, with Whittome accepting the 78/79 PSBR could be given in "general terms" linked to the level of economic activity. Whittome returned to Washington on 28 November having advised Wass he felt the cuts laid out in third package would be acceptable for 77/78 but that a further round of cuts would be required in 78/79 unless the economy was growing slower than the IMF assumed.²²⁰

At gruelling round of Cabinet meetings on 1 December Healey proposed to negotiate on the basis of £1bn of public expenditure cuts and £0.5bn from the BP sales in 77/78 followed by £1.5bn of cuts in 78/89 plus a further £0.5bn in additional cuts or tax rises. Revisions of the Treasury forecasts that considered lower interest rate payments the government would need to make on its debt suggested these would now be enough to achieve a PSBR of £8.5bn for both years. Despite opposition from Crosland, Benn and Shore, by the end of the meeting Callaghan was able to summarise that Healey had the support of the Cabinet. However, Witteveen himself had arrived in London on the suggestion of Ford. An unsatisfactory meeting with Callaghan and Healey followed, where he explained the £1bn of "real" cuts in 77/78 were unsatisfactory.²²¹

Following another Cabinet meeting on 2 December, at which the exact nature of the proposed cuts was agreed, Healey informed Whittome that he had authority to reduce the PSBR in 77/78 to £8.7bn on the basis of £0.5bn BP sales and £1bn expenditure cuts. Tentative agreement had been reached on further adjustment in 78/79 of £2bn but this would be discussed at a Cabinet meeting on 6 December.²²² Whittome communicated this to Witteveen, but at a meeting with Healey on 3 December reported that the IMF managing director had asked for a greater adjustment of £1.5bn of

²¹⁹ TNA PREM 16/803 "IMF negotiations" 25 November 1976.

²²⁰ Wass *Decline to Fall* p279, p281

²²¹ *Ibid* pp. 291-292

²²² *Ibid* p293

cuts in 77/78 and £3bn in 78/79. Healey famously replied “Dr Witteveen could take a running jump.” An impasse loomed. Whittome felt able to sell the 77/78 cuts but argued Witteveen would require more than £2bn in the second year. In response Healey argued he had not yet secured agreement even for £2bn. He suggested Whittome give his boss an account of Callaghan’s thinking. While failure to reach agreement with the IMF would cause the fall of the government, so too would accepting Witteveen’s proposals then failing to get them past the party and parliament. Healey claimed Callaghan would rather go down fighting the IMF than his own party. He might even win an election called on a change of economic strategy that enabled Britain to “go it alone.”²²³

In response Whittome proposed to negotiate on the basis that a large adjustment in the second year was contingent on the upswing in the British economy that the Fund foresaw. In response Healey and Whittome agreed a draft which proposed an adjustment between £500m and £1bn if the rate of growth between the beginning of 1978 and end of 1979 was more than 3.5%.²²⁴ With this compromise in place both Witteveen and Callaghan agreed to the scope of the adjustment and work could begin on the Letter of Intent that detailed the specific commitment to public spending and DCE.²²⁵

The cut and thrust of the IMF negotiations means that attention has inevitably focused on the contentious debates over the PSBR, while analytical debate has centred over whether IMF conditionality imposed a shift in economic policy on Labour or whether this was undertaken previously of the government’s own volition. However in separating the essentially domestic debate over government economic policy from the international debate over what to do about the sterling balances, these analyses overlook the true significance of the IMF deal from the perspective of the Callaghan government, namely that it was part of a wider package aimed at definitively resolving

²²³ TNA PREM 16/805 “Note of a Meeting Held a Number 11 Downing Street” 3 December 1976

²²⁴ TNA PREM 16/805 “Note of a Meeting Held in the Chancellor’s room, Treasury Chambers on Friday 3 December” 4 December 1976

²²⁵ TNA PREM 16/805 “Note from Wass to Healey” 5 December 1976

sterling's international status. As the Prime Minister explained to Lever in a call while the latter was in Washington:

I don't think that we can take it separately. They have got to be taken together. There has got to be something to be sold to our people. The sterling balances, they have got to be part of it.²²⁶

While Rogers has argued that Callaghan used the imposition of IMF conditionality to depoliticise the consequences of his chosen economic policy, from the perspective of international negotiation we can see he was equally adept at threatening the collapse of his domestic political base to secure foreign commitment to a sterling balance facility. Callaghan's major objective across the crisis was to resolve the sterling balance problem, hence his narration of the crisis as stemming primarily from the existence of the balances. Given that the Ford administration was clear that discussions on an additional facility could only begin once the IMF negotiations had concluded, conditionality was entered into on the understanding that this would then secure the international support needed. Negotiations with the Fund revealed that Labour's interpretation on the medium-term prospects for sterling was much more positive and they resisted attempts to tie down British policy beyond the forthcoming year. However they also recognised that an impression of conditionality needed to be given (hence talk over whether proposed cuts would be "enough blood" for the Fund) in order to impress market opinion as part of a wider reappraisal of confidence in sterling. This means that agreement with the Fund was only the penultimate stage, as attention now turned to the exact type of support Callaghan could extract from the Americans.

6.11 Negotiating the Third Group Arrangement – November 1976 – February 1977

Throughout the negotiation of the IMF standby, work had been proceeding on what facility could be available for sterling. On 25 November, a Treasury paper outlined the scale of the problem. Since the last arrangement in 1968 the size of the balances had nearly doubled from £3.4bn to £6.2bn. Of

²²⁶ TNA PREM 16/801 "Transcript of a Telephone Conversation Between the Prime Minister and the Chancellor of the Duchy of Lancaster" 18 November 1976

these balances, the ones held by official bodies were the more volatile, having risen steadily under the terms of the 1968 arrangement and peaking at £4.9bn in March 1975 before dropping back to £2.8bn by the end of 1976. The danger therefore was that a further mass diversification would absorb the forthcoming IMF money.²²⁷

Work between the Bank of England and the BIS had proceeded throughout the IMF negotiations, with the BIS producing a paper similar in outline to British proposals, albeit with an exchange guarantee. It was hoped that once agreement was reached with the IMF, work on the safety net would progress sufficiently for the Chancellor to announce them simultaneously on 15 December.²²⁸ This however depended on the attitude of the Americans. Ford had given his agreement that work would progress on the sterling balances once the IMF deal was signed but having lost the election to Carter on 2 November, the British were concerned the US Treasury would scupper the deal. Simon continued to believe that once the right policies were in place the balances would cease to be a problem, to which Healey replied that the issue of confidence among sterling balance holders meant the presentational value of the safety net was extremely important.²²⁹

Simon was concerned that a separate deal on the sterling balances would allow the British to circumvent the Fund's conditionality. Previous support for sterling had in effect "provided continuous underwriting of the sterling balances," allowing successive British governments to pursue inappropriate policies.²³⁰ A more influential actor was now Burns, who would remain in office into 1977. A memo prepared for him considering the pros and cons of the safety net considered the economic argument weak. The volatile elements of the sterling balances – around \$2.4bn or probably less – could be financed by the IMF standby and borrowing on the Eurodollar markets. Additionally, the facility might encourage the very switching it was designed to avoid, inciting

²²⁷TNA T381/8 "A Possible Third Group arrangement concerning the Sterling Balances" 25 November 1976

²²⁸ TNA T381/8 "Safety Net State of Play" 25 November 1976

²²⁹ TNA T381/8 "Note of a Meeting" 28 November 1976

²³⁰ FRUS 69-76 Vol. E-15 Part 2 "Memorandum From Secretary of the Treasury Simon to President Ford" 17 December 1976

holders to get out while the going was good. More promising for the British were the political arguments. It was recognised that given the build-up of expectations regarding a facility for balances it would be dangerous to now disappoint them. The flipside of the weakness of the economic case meant the facility would be small and cheap.²³¹ While in London on the 29 November Yeo spoke to Richardson to convey Burns' current thinking on the issue. Yeo claimed Burns was sympathetic but like Simon did not recognise the balances as the principal problem and was not prepared to discuss them until after agreement was reached with the Fund.²³² However, Yeo also gave the impression he was now "resigned" to a Basle type facility with an accompanying dollar bond issue.²³³

With agreement of the Fund secured at the beginning of December, Callaghan looked to expedite discussions on the sterling balances. In his letter to Ford on 2 December outlining the details of the agreed public spending cuts, he warned the President that he was "not sanguine," about being able to carry the country with him.²³⁴ In a later letter, he claimed he would not be able to persuade the unions or the Labour parliamentary party to support the IMF deal without agreement on a sterling safety net.²³⁵ In order to win public support he wanted to make a specific reference to a facility for sterling when announcing the IMF deal in the House of Commons on the 15 December. He informed Ford of the specific statement he wanted to make:

President Ford has indicated to me that he will be recommending Congress to approve United States participation in this facility and I now expect that negotiations on it can be brought to a speedy conclusion.²³⁶

²³¹ TNA T381/8 Tel No 3959" 28 November 1976

²³² TNA T381/8 "Conversations between the Governor and Ed Yeo 28th and 29th November" 29 November 1976

²³³ TNA T381/81 "Sterling Balances: Yeo's Visit to the Bank" 29 November 1976

²³⁴ FRUS 69-76 Vol. E-15 Part 2 "Memorandum From the President's Assistant for National Security Affairs (Scowcroft) to President Ford" 02 December 1976

²³⁵ FRUS 69-76 Vol. E-15 Part 2 "Memorandum From the President's Assistant for National Security Affairs (Scowcroft) to President Ford" 09 December 1976

²³⁶ FRUS 69-76 Vol. E-15 Part 2 "Memorandum From the President's Assistant for National Security Affairs (Scowcroft) to President Ford" 02 December 1976

While Callaghan had secured domestic commitment to the IMF deal by presenting it as the only option to stabilise sterling and secure a Labour government, in economic diplomacy he was also prepared to leverage domestic opinion itself (specifically the threat of an adverse reaction and the fall of Labour's government) to secure international support for his wider objective of resolution of the sterling balances. Once again Callaghan made clear in his dealings with Ford that acceptance of the IMF deal could only be achieved as part of a wider package that involved some international commitment to resolving the sterling overhang.

However, the belated attention of Yeo and Burns to a safety net now threatened to slow down progress. A leader in the *New York Times* that was assumed to be sourced from Yeo insinuated the British were "fuzzy" in their ideas regarding the safety net. Healey complained to Kissinger about Burns' and Yeo's obstructive attitude and requested Kissinger lean on Burns to engage with discussions underway in Basle.²³⁷ Mitchell was dispatched to Washington on 12 December in an attempt to finalise the details with Burns and Yeo, however found Burns "immovable" on the suggestion that his delegate Walich take part in the Basle discussions. Burns apparently considered the sterling balances a problem for the British rather than the rest of the world that could be easily solved with exchange guarantees if the British government could not enact the appropriate domestic policies. Callaghan's repeated interventions to Ford had upset Burns who claimed the Prime Minister failed to appreciate the independence of the Fed. Embarrassingly for Mitchell, Yeo then took the opportunity to read out Callaghan's message from the previous day, provoking Burns into "another tirade about the Fed's independence" and demanding Mitchell report back that the timetable required of the Americans was impossible.²³⁸

Meeting Yeo alone later that day, Mitchell found him slightly more forthcoming. Yeo agreed in principle to the safety net, on the condition it applied to public balances only and was tied to

²³⁷ TNA T381/9 Safety Net 10 December 1976

²³⁸ TNA T381/9 "Tel No 4184" 12 December 1976

commitments to eventually reduce and eliminate the balances. While Yeo's proposal for a dollar bond offer to facilitate switching out of the currency was uncontroversial, his demands for conditionality were. Yeo wanted the facility operated via the IMF and subject to the same conditionality as the third and fourth credit tranches. This reflected Simon's belief that if something was to be done about the sterling balances it was better to deal with them over the medium term in a forthright manner rather than via a safety net which provided finance nominally on a short-term basis but with the option of rolling over funds over several years – "a medium-term facility in short term clothing." In this case the costs and risk would be spread across the system, with OPEC countries contributing to the funds provided. In contrast, the safety net would provide OPEC sterling holders with lucrative interest rates and (Simon believed) exchange guarantees, while only the West would be required to put up money.²³⁹

Mitchell was understandably taken aback by this last demand, noting that it was a radically different proposition to the one being considered in Basle. Much previous work had been done on funding in the Committee of 20 but this had elicited little support during previous rounds of reform. Yeo's proposed scheme would take many months to negotiate and implied an element of compulsion on sterling holders that would inevitably provoke them to switch out of the currency.²⁴⁰ In a memo passed to Kissinger the next day it was pointed out that although intended only for official balances, Yeo's scheme would require controls on private balances also, which was "hardly consistent with London remaining a major financial centre." The British were adamant that they would not accept a scheme in which withdrawals were linked to IMF conditions.²⁴¹

Breakfasting with Yeo and Burns on the 13th, Mitchell took the opportunity to debate the relative benefits of the Basle and Yeo schemes. Burns notably did not endorse his colleague's proposals and

²³⁹ FRUS 69-76 Vol. E-15 Part 2 "Memorandum From Secretary of the Treasury Simon to President Ford 17 December 1976

²⁴⁰ TNA T381/9 "Tel No 4187" 12 December 1976

²⁴¹ FRUS VOL. E15 Part 2 "Note From the Government of the United Kingdom to Secretary of State Kissinger" 13 December 1976

conceded Mitchell's argument that deliberate run down of the balances would be difficult to organise and might produce panic. However, he held firm regarding the Basle negotiations, claiming his attitude was "God bless all central banks that wanted to support it," – not particularly helpful since they would not proceed without American involvement.²⁴² Reporting on the discussions Wass informed the Prime Minister that he now had "serious anxieties" about the prospect for the safety net and advised concentrating efforts on the meeting in Paris the next Monday.²⁴³ Callaghan was much more irate and threatened to send Ford an angry letter but was talked down by his Treasury advisors who thought it unwise to jeopardise relations at this critical juncture.²⁴⁴

The news from Basle was no more heartening when Richardson called to report to Wass later that day. Discussion on the wording of the Chancellor's statement on 15 December revealed exception taken at the word 'willingness' being used to describe the delegates feeling towards the project. The revised statement dropped the reference to the Fed, speaking only of "discussions being taken forward in Washington," and the "general desire" on the part of those concerned to resolve the issue.²⁴⁵ Callaghan was disappointed by the statement but recognised there was not much chance of amendments given the tight deadline.²⁴⁶

Having been unable to secure the commitment on the sterling balances by the 15 December, Healey announced the details of the IMF arrangement without them.²⁴⁷ Presenting the IMF agreement as the means to "achieve the fastest possible return to a high and sustainable level of employment," Healey was on his feet for half an hour in what appeared to the American ambassador as a "particularly boisterous – somewhat raucous – House of Commons." Healey stressed that the adjustment would come in the form of expenditure cuts rather than tax rises and downplayed the severity of the cuts. After detailing the cuts in food subsidies, defence, export credits, local

²⁴² TNA T381/9 "Tel no 4208" 13 December 1976

²⁴³ TNA T381/9 "Safety Net" 14 December 1976

²⁴⁴ TNA T381/9 "Letter from N Monck to K R Stoew" 15 December 1976

²⁴⁵ TNA T381/9 "Note for The Record" 13 December 1976

²⁴⁶ TNA T381/9 "Tel no 413" 13 December 1976

²⁴⁷ TNA T381/9 "Safety Net" 14 December 1976

government as well as raises in duties and the sales of the BP shares, Healey turned to incomes policy and inflation. Healey reiterated the policy that if pay rises were moderated and it would not take the 77/78 PSBR above £8.7bn then there would be scope for reduction in taxes, demonstrating that even after the IMF deal the union relationship continued to be at the forefront of government strategy. On the sterling balances he referred to the on-going discussions in Basle and Washington and as agreed in Basle, the “general desire” on the part of those concerned to achieve as “satisfactory arrangement” for the sterling balances.²⁴⁸

The reaction was mixed. One member of the House complained that the government was trading away the nation’s sovereignty, to which Healey replied that the endorsement of the IMF of Britain’s policies would do much to improve the country’s economic prospects. The Sun newspaper the following day carried the headline “Britain’s Shame.”²⁴⁹ However in his report to Washington, the American ambassador quoted a senior trader expressing surprise that the UK was able to arrange an IMF loan on such easy conditions, while expressing his own view that once again domestic politics had got in the way of the necessary structural adjustment. On the narrow grounds of meeting IMF conditionality the measures would succeed but it was in doubt whether this would be sufficient to restore confidence more generally among Britain’s creditors. What cuts had been announced were seen as ineffectual. The ambassador concluded by noting “The Chancellor has once again produced a package which pleases no one, neither the left wing of his party nor the opposition nor the markets,” but conceded the markets might take a more favourable view in the longer term upon reflection.²⁵⁰

As the report revealed, the perception in Washington was that Britain had still not entirely taken measures to resolve the crisis according to their analysis that the fault lay in domestic policy and

²⁴⁸ FRUS VOL E15 Part 2 Telegram 20294 From the Embassy in the United Kingdom to the Department of State 15 Dec 1976

²⁴⁹ Quoted in Financial Times “Defining Moment: Denis Healey agrees to the demands of the IMF” [online] <http://www.ft.com/cms/s/2/11484844-b565-11df-9af8-00144feabdc0.html> (accessed 14 July 2015)

²⁵⁰ FRUS VOL E15 Part 2 Telegram 20294 From the Embassy in the United Kingdom to the Department of State 15 Dec 1976

continued to resist demands for further support for sterling that might loosen the impact of the IMF deal. This continued American resistance forced the British to reappraise their demands. The insistence on linking eligibility on drawings to IMF conditionality made one Treasury memo suggest considering “whether American pollution of the position so far reached in Basle is such as to render the whole facility not worth having.” The Treasury now recognised private balances were unlikely to be covered and hence the size of the facility would be correspondingly smaller. Although no specific amounts had been discussed, the Americans appeared to be thinking in the region of \$2 - \$2.5bn.²⁵¹ Accordingly Mitchell sought to manage the Chancellor’s expectations downwards, advising also to give some consideration to what measures could be taken to prevent a future build-up of the balances.²⁵²

Callaghan wrote to Ford on 16 December to express his strong preference for the safety net facility being worked out in Basle. While not discounting the appeal of a funding approach, he argued it would take too long to organise to be of any help. Ford’s advisor Scowcroft suggested he make clear to the US Treasury the nature of his personal commitment to Callaghan and the need for a quick solution on sterling.²⁵³ In his reply to Callaghan on the 19th, Ford reported that Yeo would attend the Paris meeting with a spirit of “sympathy, understanding and flexibility,” while also highlighting the political pressures he himself was under to deal with the problem in a comprehensive and sustainable manner.²⁵⁴

The moderation of British expectations and relaxation of American hostility to the scheme ensured progress when the two sides met in Paris on 20 December. Holmes from the Fed claimed that to receive congressional approval, the safety net would need conditionality linked to the IMF drawing.

²⁵¹ TNA T381/9 “Discussion on Sterling Balances at Basle 12 - 14 Dec” 16 December 1976

²⁵² TNA T381/9 “Progress on Safety Net” 17 Dec 1976; T381/9 “A Safety Net and the Future of the Sterling Balances” 17 December 1976

²⁵³ FRUS 69-76 Vol. E-15 Part 2 “Memorandum From the President’s Assistant for National Security Affairs (Scowcroft) to President Ford” 18 December 1976.

²⁵⁴ FRUS 69-76 Vol. E-15 Part 2 “Message From President Ford to British Prime Minister Callaghan” 19 December 1976

Eligibility to draw on the IMF standby would be sufficient during its two-year duration, after which the US would require a certificate from the IMF that stated the Fund's approval of the United Kingdom's policies. While there was a "general sympathy" with the American's ideas, the consensus following discussion was that, being a central bank facility, it could not depend on IMF conditions. Moreover, since the safety net was in part designed to provide liquidity for Britain's foreign currency bonds, any formal disqualification of Britain's right to draw would jeopardise the success of them. Therefore, while no formal link to the IMF would be included, it was suggested British performance under its Letter of Intent and regular consultations would enable the BIS to form its own independent judgement on whether further drawings were permissible. This was a similar type of loose conditionality (based on judgement of individuals rather than objective criteria and hence amenable to greater personal diplomacy) that had characterised borrowing from the Fund post devaluation.

In the afternoon discussion turned to the mechanics of the safety net. While the Europeans were in favour of covering both official and private balances, the Americans were adamant that it would apply only to official ones. This meant less money would be required, with the Americans pitching \$2bn, finding agreement from French and Germans who accepted American insistence on excluding private balances. The Americans accepted a drawdown period of 3 years but argued a repayment period of 10 was too long.²⁵⁵ Reporting back on the meeting, Healey advised Callaghan that they may have to revise downwards their expectations in terms of size and coverage but would be able to mitigate demands for meaningful conditions with regards to future accruals.²⁵⁶

A report was produced on the sterling facility to be considered by the Governors at a meeting in Basle in January. Progress was now swift and despite some technicalities regarding the dollar bonds that needed to be resolved, the Treasury was optimistic that agreement could be reached on a \$2bn

²⁵⁵ TNA T381/81 "Safety Net: BIS Group Talks in Paris, 20 Dec" 21 December 1976

²⁵⁶ TNA T381/81 "Progress on the Safety Net and the Future of Sterling" 21 December 1976

facility for the official balances with only “fairly broad brushes of intent” on preventing future accruals. Yeo continued to push complicated ideas on conditionality at a working lunch between the German, American and British treasuries but his ideas were not taken seriously as they were expected to “wither on the vine when [he] does – or even before.”²⁵⁷

To finalise these details McMahon of the Bank of England and Mitchell of the Treasury travelled to Washington for a meeting with Burns and Yeo on 6 January. Yeo gave the impression that he had softened on the question of conditionality and role of the IMF but remained committed to phasing out sterling.²⁵⁸ The next day they agreed the form of a paper to be presented by Burns at a Basle meeting. The Americans pushed for a target figure of private balances but the British successfully resisted any firm undertakings towards this end, believing it might jeopardise London’s status as a financial centre.²⁵⁹

While Callaghan was disappointed with the size and scope of the facility being discussed, the Treasury felt that \$3.5bn was the maximum that could be hoped for and the most likely outcome was pushing the Americans up from \$2 to \$2.5bn. The Treasury was prepared to accept having drawings linked to the conditionality of the IMF standby over the two years that was in operation while resisting tight conditionality for later years, particularly when the draw down period had passed and when the United Kingdom was making any repayments due.²⁶⁰ Together with Mitchell from the Treasury, McMahon spent the 7th January negotiating with Yeo and Burns on a paper the latter would present in Basle on the coming weekend. According to the Treasury report, the British delegation spent a lot of time dissuading Yeo from linking the Basle facility to IMF conditionality, as per Callaghan’s instructions. While the final paper stated that the IMF Managing Director would review the progress of reducing sterling’s reserve role, performance on this was to be assessed by

²⁵⁷ TNA 381/81 “Sterling Safety Net Discussions in Paris 20 - 22nd December” 29 Dec 1976

²⁵⁸ TNA T381/81 “Arrangements Safety Net and the Future of the Sterling Balances” 6 January 1977

²⁵⁹ TNA T381/81 “Facility for the Sterling Balances” 07 January 1977

²⁶⁰ TNA T381/81 “Arrangements for Sterling Balances” 4 January 1977

the “vague criterion of ‘reasonable efforts to meet the undertakings’.”²⁶¹ Although the paper proposed the British would become ineligible to draw upon the BIS facility if in the judgement of the Managing Director Britain was not making reasonable progress in reducing sterling’s reserve role, at the Basle meeting on 9 January Richardson did not permit a definition of the exact level of working balances to be targeted, nor that the IMF executive board should have oversight of progress, only the Managing Director himself.²⁶² The final deal accepted that eligibility to draw would be linked to drawing on the IMF standby, as well as a commitment to exercise restraint with respect to future increases in private sterling balances.²⁶³

Under the terms of the deal, participating central banks would make available a \$3bn credit via the BIS that could be drawn upon to stabilise sterling if the official sterling balances fell below \$2.165bn, a base level set from the 8 December and Britain’s reserves fell below \$6.75bn.²⁶⁴ This credit would be available for seven years.²⁶⁵ As part of the deal Britain was committed to running down official balances to a working level, and to prevent them building up again. Conditionality to draw was linked at American insistence to the IMF’s Managing Director agreeing the UK was making reasonable progress towards this end. A foreign currency bond offer would facilitate those who wanted to switch out of sterling.²⁶⁶

The announcement of the Basle facility resulted in a strong positive reaction in both the press and the markets. There was a common recognition that the Basle facility, and more importantly, the commitment to run down the sterling balances to the level of working balances, constituted a historical moment. As the *Financial Times* commented, the deal provided an opportunity to complete what had been the nominal objective of British policy at least since the Rippon

²⁶¹ TNA T381/81 “Facility for the Sterling Balances” 7 January 1977.

²⁶² Schenk *The Decline of Sterling* p390

²⁶³ TNA T381/81 “Agreement of Participating Central Banks on Main Components of Sterling Balance Facility” 11 January 1977

²⁶⁴ T382/83 “Basle Agreement” 11 February 1977

²⁶⁵ Hoffmeyer *The International Monetary System* p52

²⁶⁶ *Ibid.* p53

commitment in 1971: ending sterling's reserve role. According to the *FT* "there is now a potentially happy ending to what has been an increasingly disgraceful story."²⁶⁷ There was positive comment on the deal in both Europe and America, with the Treasury noting the conditionality attached to the deal attracted relatively little attention.²⁶⁸ As part of the deal to facilitate a rundown of the balances, Britain made available a foreign currency bond offer, of which no more than 75% was to be in dollars. According to Treasury estimates in February, the current level of sterling balances was around £1bn above working levels, which meant it was envisaged selling £500m of bonds.²⁶⁹ However visits to major sterling holders in the Middle East revealed despite a general sympathy towards the plight of sterling, holders viewed the current strengthening of the currency as an opportunity to recoup some of their losses over the previous year and therefore expected a generous terms on the bond to be induced to switch.²⁷⁰

The result of the combined IMF and BIS deals appeared to transform the plight of the British economy, at least from an external perspective. The UK drew on the IMF standby three times, but after the third drawing in August 1977 began repaying the IMF.²⁷¹ As short-term reserves had surged from \$5bn to \$20bn in 1977, finishing the decade at \$30bn, Britain was unable to draw upon the Third Group Arrangement, as short-term reserves remained far too high above the trigger points. However, as sterling's short-term assets finally outweighed short term liabilities, the sterling overhang was resolved.²⁷² In the end it was the endorsement of the international community, mediated via the IMF and BIS, as well as British commitment to ending sterling's reserve role that transformed market sentiment regarding the sterling balances.

²⁶⁷ *Financial Times* 11 January 1977

²⁶⁸ TNA T381/82 "Sterling Balances: US Press reaction" 12 January 1977; TNA T381/82 "Safety net – further press action" 12 January 1977

²⁶⁹ TNA T381/82 "Sterling Balances: Foreign currency Bond Offer" 10 February 1977

²⁷⁰ TNA T381/82 "Official Sterling Balances" 24 January 1977

²⁷¹ *Wass Decline to Fall* p310

²⁷² *Cappie Bank of England* pp. 761 - 763

6.12 Epilogue November 1978

By the end of 1978, the sterling balance that had so haunted policymakers for the past 10 years had largely ceased to be a problem. Significantly however, discussions within the Treasury and between Callaghan, Healey and the Bank reveal the extent to which the sterling balances and wider concerns about external constraints continued to haunt Labour even following the overwhelming endorsement of markets that occurred at the beginning of 1977. As Healey reminded Callaghan in November 1978, a key issue remained IMF conditionality. Participating central banks had insisted that Britain would only be able to draw on the facility if it maintained access to the IMF standby. Since the standby was only for two years while the Basle facility could be extended to a third, it had been made clear that some other form of conditionality would have to be substituted for the “IMF’s seal of good housekeeping for our domestic policies.”²⁷³

To secure an extension of the facility therefore would require either asking for an extension of the IMF standby, or asking central banks for some alternative form of conditionality, accepting that this would most likely result in them asking the IMF for help, as they had in 1976 when the Managing Director was asked to supervise Britain’s sterling balance policy. Healey advised

I do not believe that this would be a viable course given the general political difficulties of justifying IMF conditions to the Labour party.²⁷⁴

The combined advice of the Treasury and Bank was therefore that the facility should be allowed to lapse as continuing it would involve, in one way or another, re-subjecting Britain to the IMF’s conditionality. Following disagreement with the Fund in May over performance criteria for 78/79 (during which the Fund had let things slide based on the expectation that there would no further

²⁷³ TNA T381/99 “The Basle Net for the Sterling Balances” 7 November 1978

²⁷⁴ *Ibid.*

drawings or extension of the standby), a substantive re-negotiation raised the possibility of further conflict over the appropriate policy mix.²⁷⁵

Callaghan readily agreed that the facility could therefore lapse but then asked whether there was now any prospect of reducing sterling's reserve currency role, noting there was much talk of this in 1976 but not much progress in the past two years to reduce the sterling balances held abroad by central banks.²⁷⁶ In response the Governor of the Bank of England was reportedly "very indignant" at Callaghan's suggestion that nothing had been done, writing personally to advise that the fall in sterling's share of world reserves suggested it had "ceased to have any significant role as a reserve currency."²⁷⁷ Within the Treasury and Bank of England the view was that there had been significant success in reducing sterling's reserve role. The foreign currency bond offer in April 1977 allowed holders to purchase bonds denominated in dollars, Deutschmarks, Swiss francs or yen, with over £390m subscribed. It had also been made clear in official announcements that foreign holdings of sterling should be kept to working balances, with the Treasury monitoring upward movements in balances held and taking the matter up with the country involved. The conclusion was that the fall in the sterling balances from £2.1bn in mid-December 1976 to £1.8bn in October 1978 during a time when world reserves had grown rapidly meant that official balances did not now exceed working balances.²⁷⁸ Healey concluded:

I think it would be wrong to give the impression that we cannot walk without this crutch and have no confidence in our own ability to apply sound policies to the management of the economy.

The overhang resolved, Labour had maintained its commitment to the principles of embedded liberalism, preserving domestic policy autonomy within a stable trading network.

²⁷⁵ TNA T381/99 "The Basle Safety Net and the IMF Standby" 3 November 1978

²⁷⁶ TNA T381/99 "The Basle Safety Net for the Sterling Balances" 10 November 1978

²⁷⁷ TNA T381/99 "Letter from DH to M Barrat" 24 November 78; TNA T381/99 "Letter from George Richardson to the Prime Minister" n.d.

²⁷⁸ TNA T381/99 "Official Sterling Balances" 24 November 1978

Chapter 7

Conclusion

The thesis has examined the evolution of foreign economic policy between sterling's devaluation in 1967 and the final resolution of its reserve role in 1977. Despite the continuous concern of policy to find a resolution to the sterling overhang, paradoxically this period witnessed a renewed accumulation in the level of the balances, reversing the decline that had precipitated devaluation. Notwithstanding commitments made as part of Britain's third EEC application in 1972, only in 1976 as part of the IMF crisis did running down sterling's reserve role finally become the objective of policy. Foreign currency bond offers and the 1977 Basle deal succeeded where other support packages had failed, running down foreign holdings of sterling to working balances, while short term assets built up to the extent that the overhang was finally resolved.

This process has been explained through a constructivist approach to monetary relations. The constitution of the external constraint faced by Britain as a result of the sterling overhang was interpreted through the prism of Britain's commitment to the post-war principles of embedded liberalism. Securing stability in external exchange and autonomy for domestic expansion assumed priority, prior to 1976, of resolving the sterling overhang. The impact of the overhang on domestic expansion was instead moderated through a continuous process of negotiation, leveraging Britain's commitments to the wider monetary system to secure international support for sterling.

The thesis has traced the process of policy formation and economic diplomacy as the Treasury and political leaders responded to shifts in the international monetary system and engaged with processes of reform to improve the terms of Britain's interaction with the global economy. Immediately following devaluation, resolution of the sterling balances was interpreted through the prism of defending and reforming Bretton Woods. The external constraint was accordingly

constituted by Britain's adherence to system's provision of adjustment, liquidity and confidence. While successful in stabilising and reforming Bretton Woods in the short run, defence of the post-devaluation parity involved submitting to rigid constraints. Britain was required to assume higher external debt and restrict public spending more than would have been the case in the absence of these commitments. Inducements encouraging holders to maintain their sterling balances proved so attractive they facilitated the beginning of the renewed accumulation that had to be resolved in 1976.

The constraint was therefore determined by the ideological commitment to the principles of embedded liberalism that was embodied in the Bretton Woods system. This was justified based on the fear that a collapse in the system would herald a return to the political and economic conflict of the interwar period, combine with hopes that general reform to the role of reserve currencies would resolve the issue of sterling. Narration of sterling crises as implying a systemic threat to Bretton Woods secured support for sterling to maintain Britain's commitments during this period of adjustment.

The thesis argues that a significant shift in this approach occurred with the Nixon Shock of 1971. American unilateralism and the undermining of Bretton Woods meant expansion of domestic policy autonomy now took priority over stabilising the international monetary system. With adjustment now flexible in response to floating the rate in 1972, international borrowing, domestic retrenchment and use of the reserves were considered less appropriate responses to a current account deficit. Despite the Rippon commitment to run down sterling's reserve role as part of the process of joining the EEC, no measures were taken to do so. Instead the configuration of the external constraint was predicated on domestic expansion. The exchange rate guarantees of the 1968 Basle deal were extended to stabilise confidence in the balances. While policy continued to be based on the search for a long term resolution of the sterling overhang, as demonstrated by Heath's attempts to use an acceleration of European monetary union to pool assets and liabilities, his refusal

to accept any renewed commitments for sterling indicates the interest of securing autonomy for domestic expansion took priority over running down the balances.

This policy continued in the initial response to the 1973 oil crisis. Labour encouraged a fresh accumulation of sterling balances among newly enriched oil producers between 1974 and 75, while also drawing heavily on international capital markets in order to maintain output and demand in response to the expansion of oil related current account deficits. Growing ideological and economic divergence between Britain and America undermined the source of support that the Anglo-American relationship had traditionally provided. America wished to bring down the oil price and viewed Britain's ability to defer adjustment through borrowing directly from oil producers and via low conditionality sources of IMF funding as undermining their strategy for a common front among consuming states. Meanwhile the culmination of the process of international monetary reform in a more flexible, fiat system that financed their wider political and security objectives allowed them to contain sterling crises more effectively than in the past.

This set the scene for the 1976 crisis, in which the US attempted to use IMF conditionality to secure greater adjustment on British economic policies in line with its Treasury's neo-liberal prescriptions. In response Callaghan narrated the source of the crisis as stemming from the sterling balances, arguing that even following agreement with the IMF, diversification could overwhelm Britain's resources. This resulted in a fierce dispute with the US Treasury, which believed the problem of the sterling balances would be resolved with the correct domestic policies.

While Callaghan was forced to concede coming to terms with the Fund was a prerequisite for any additional support, facing down opposition in his own party calling for radical left-wing solutions, he also proved adept in threatening the collapse of negotiations if American support was not forthcoming. In return for a commitment to prevent any future accumulations and in combination with the offer of foreign currency bonds, the result was an overwhelming market endorsement in sterling, the resolution of the overhang and the reduction of balances to working amounts. The true

significance of the crisis, the thesis argues, was that for the first-time commitment to end sterling's reserve role took priority in policy.

As a work of economic diplomacy, the thesis captures the British side in detail, but responses from foreign counterparts are mediated through the British archives. As such a limitation of the thesis is how British assessments of crises were themselves interpreted in the foreign centres of financial support upon which sterling depended. While the thesis has traced the evolution of British policy in response to the shifting parameters of international monetary relations, it is harder to see how these parameters were themselves shifted by British policy choices.

With regards to the crucial American source of support this challenge has been mitigated to some extent by the resources available digitally via the Foreign Relations of the United States series. Analysis of this source has provided some illumination of the policy of the US in response to its own international monetary objectives. There is a substantial amount of material in these archives detailing the response of the US administration to successive sterling crises. However, there are some key areas in which the priority America attached to consideration of sterling's needs in deciding policy is less clear. More detailed archival investigation of the process of policy formation would reveal how seriously America took the British protectionist threats and the danger these posed to the international monetary system (a common theme of relations from 1967 to 1977) and the priority these had in America's assessment of crises and their response. While the Nixon Shock revealed the British assumption that sterling and the dollar had shared identities was misplaced, it is unclear whether the Americans ever felt this way and if so, how this affected their attitudes towards Bretton Woods under Johnson. Similarly, Ford's decision to throw his support behind the 1977 Basle deal, over the objections of his senior Treasury advisors, could use further investigation to understand his motivation within the context of his own objectives. Nevertheless, the true significance is clear enough from the British archives, namely the importance Callaghan attached to

coming to a further deal on the sterling balances and the final resolution of the sterling overhang that followed securing American backing.

While the thesis has re-interpreted the post-devaluation period, the years following the IMF crisis would be an interesting extension of the processes examined here. Britain's role in the co-ordinated expansion of German, Japanese and American economies of 1977 would be a suitable topic for analysis, given this was the policy Britain had been urging on them since the oil shock. While the overhang was resolved almost immediately following announcement of the 1977 deal, reducing holdings of sterling to working balances was a longer affair, requiring an ongoing process of economic diplomacy between the Bank of England and counterparts abroad. This could also be an interesting extension of the thesis to understand how this commitment to preventing a renewed accumulation of the balances imposed a constraint on policy and impacted the final years of the Labour government.

The overall conclusion of the thesis is that external constraints faced by states are not solely the consequence of economic criteria such as balance of payments deficits but are constituted according to ideologically informed commitments to wider political objectives. The continued existence of the sterling balances into 1976 reflected the use made by British policymakers in prioritising domestic autonomy and external stability over commitments that would reduce the level of foreign holdings of sterling. The external constraint was in a process of continual re-negotiation via economic diplomacy in response to both material changes in the structure of international monetary relations and ideological change, notably in the crucial American source of support.

The ability of states to pursue autonomous policies within a framework of multilateral trade and investment characterised by global capital flows is held to act as a constraint on domestic policy autonomy. In its simplest form, this overlooks the extent to which global capital markets are themselves the product of state power, ultimately dependent on them for enforcement while

shaped by political decisions regarding regulation, both domestic and international.¹ Moreover, empirical evidence casts doubt on the implication that in a world of global capital flows, a 'race to the bottom' ensues, in which policy space is constrained to choices markets find acceptable. Instead, capital retains a prominent 'home bias', while regulation varies according to the domestic institutional context.²

The thesis has argued the existence of shared normative commitments to stability in external exchange and domestic policy autonomy provided the basis for cooperation and support for weak currencies like sterling that allowed them to survive periods of weak market confidence without resorting to excessive austerity or protectionist measures. While the global capital flows are today on a much greater scale than those states contended with under Bretton Woods, there is evidence that political commitments are of continued significance in shaping the direction and scale of capital flows. The ability of Greece prior to the 2008 financial crisis to draw on global capital markets in order to pursue policies aimed at raising living standards indicates the extent to which markets are influenced by political considerations, such as Greece's membership of the Euro. The constitution of Greece's external deficits, both before and after the crisis, were determined by the of membership of the currency union. This political commitment by Greece to the Euro resulted in an uncompetitive exchange rate, an expansion of external deficits and a resulting dependence on capital markets.³ On the other hand, intra-European deficits are constituted under this arrangement as mere accounting identities, the so-called Target 2 balances, rather than real demands for Greek resources.⁴ Austerity following the crisis has raised the complaint that domestic autonomy is being sacrificed to market opinion, something British leaders in the 1960s would have found familiar. However this is the result of the continued commitment to the Eurozone which requires internal deflation rather than external

¹ Geoffrey R. D. Underhill "Markets Beyond Politics? The State and the Internationalisation of Financial Markets" *European Journal of Political Research* Vol. 19 (2/3) pp. 199 - 202

² Ben Clift *Comparative Political Economy* pp. 119-120

³ Martin Wolf *The Shifts and the Shocks What We've Learned and What Have Still to Learn from the Financial Crisis* (London: Penguin, 2014) pp 179 - 181

⁴ Hans – Werner Sinn *The Euro Trap On Bursting Bubbles, Budgets and Beliefs* (Oxford: Oxford University Press, 2014) pp. 183 - 185

adjustment through devaluation.⁵ Under this configuration of its external constraint, Greece is reliant on international sources of support to negotiate the impact. Unlike Britain in the 1970s, Greece has failed in its attempt to seize control of the narrative of the crisis, notably in its 2015 referendum on the terms of the Euro bail out which attempted to position the moral authority of a democratic mandate as superior to the terms of Greece's creditors. Ideological differences between the left-wing Greek government of Syriza and the conservative German CDU proved unbridgeable, with the Germans demanding a commitment to austerity as the price of support required to stay in the Eurozone.⁶

Political commitments therefore shape the external constraints economies are submitted to and the availability and conditionality of support required to manage them. This is most dramatically revealed at times of crisis. Crises such as the Nixon Shock and OPEC crisis indicate the extent to which political decisions with wider geopolitical and security objectives can re-configure the external constraint. The strength of relationships with international sources of support thus proves essential in states' ability to negotiate this constraint. Despite different interpretations of the crisis in 1976, the Anglo-American relationship proved strong enough for Britain to be able to secure the additional support it deemed necessary.

The economic implications of Brexit are unclear at the time of writing, but likely to involve a reconfiguration of external constraint. Although the sterling balance problem no longer exists in the same form (as Britain's external liabilities now taking the form of equity or long-term debt rather than short term Treasury bills), Britain's seemingly perpetual current account deficits reveal a continuing dependence on external support for its standard of living. The radical reinterpretation of Britain's political commitments and relationships can be expected, like Heath's first abortive attempt

⁵ *Ibid* p135

⁶ Adam Tooze *Crashed How A Decade of Financial Crises Changed the World* (London: Allen Lane, 2018) p530

to engage with Europe on a monetary level, to result in isolation from international sources of support while at the same time making them more necessary.⁷

⁷ *The Economist* 15 October 2016

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