The IMF Crisis, 1976
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Ladies and gentlemen, this is the third lecture in a series on post-War political crises, and this lecture is on the 1976 crisis when Britain was forced to borrow money from the IMF, the International Monetary Fund, and in return, to allow IMF supervision of its economic policies. The then-Labour Government was divided on its response to the IMF terms and there was a long Cabinet battle before they were accepted, so the crisis was both an economic one and a political one. It has seemed for many to be a watershed, both in economics and in politics.

In economic policy, it seemed there was a shift away from Keynesian methods of economic management, that is, the fine-tuning of the economy to control instability, inflation and unemployment, towards monetarism, which involved accepting a higher level of unemployment.

But it was also a political, and in a sense an ideological, crisis because it seemed to be a crisis for the British version of social democracy, which relied on high levels of public spending to sustain the welfare state, and it prefigured the rise of Thatcherism and the long period of Conservative dominance which began in 1979. The crisis ended the post-War consensus on economic policy and prefigured the growth of a new consensus based around the idea of a limited state, so I think the crisis casts a shaft of light on the whole evolution of post-War economic policy.

But in fact, as I shall argue, the loan from the IMF was less of a turning point than a confirmation of a turning point that had already occurred, and what the IMF loan did was to give an international seal of approval to the shift of economic policy and so make it appear legitimate, but it did highlight the difficulties of applying the doctrines of social democracy in a globalised economy and therefore caused a long evolution in Labour politics to Tony Blair's New Labour in the 1990s. This crisis was as much a crisis of social democracy as it was one on the British economy.

Now, 1974 to 1979, those years proved to be the last Labour Government for 18 years, and it was a Labour Government under Harold Wilson from 1974 to 1976, and then under James Callaghan from 1976 to 1979, and it had to handle the economic crisis with a very small majority. Indeed, it had come to power unexpectedly in March 1974 as a minority government without a majority at all. In October 1974, it won a small overall majority of three, which was rapidly eroded by defections and by election losses.

In April 1976, Callaghan succeeded Wilson as Prime Minister, but by July, his Government had lost its majority and it was therefore a minority government again, and by the time the IMF crisis erupted, in September 1976, Labour was a minority government. It was a weak government, lacking a strong parliamentary base from which to pursue tough policies.

The first Labour Prime Minister in 1974 was Harold Wilson, and he is the only post-War Prime Minster to enjoy, as it were, a second innings. He had been Prime Minister from 1964 to 1970, and 14 of his Ministers in this new Government in 1974 had also been in that earlier Government, so this new Government in 1974 was not short of ministerial experience, and indeed, Wilson says in his memoirs that the 1974 Cabinet was "richer in experience than perhaps any incoming government this century", but it was a very divided Government that came to power in the midst of quite unforeseen and unprecedented economic difficulties.

Now, in opposition, the Labour Party, as perhaps often happens with the Labour Party, it had moved to the left after its defeat in 1970, and the left had said that the Wilson Government had betrayed the principles of socialism and the next one should make a much more radical attack on inequality. Tony Benn, who was the leader of the left and, of course, the father of Hilary Benn, who is not the leader of the left, Tony Benn demanded an irreversible shift towards working people. Michael Foot, who was another leader of the left, was also in the new Government in 1974 and, under Callaghan, was to become Deputy Prime Minister. So, it was a Government in which the left wing was very strong and determined to ensure that this Government in 1974 did not do what the previous Government had done, in their view, namely to betray the principles of socialism.

One minister in that Government, Joel Barnett, who was Chief Secretary of the Treasury, later said in his memoirs that the Party was "...so divided that it is difficult even to regard it as a coalition", and he said: "There is no comparable example of such intellectual and political incoherence in a Party coming to office in the 20th century history of the United Kingdom."

Now, it had to deal with an appallingly difficult economic situation that was really quite unprecedented. In February 1974, just before the General Election at which Heath's Conservatives were defeated, the National Institute for Economic & Social Research said this: "It is not often that a government finds itself confronted with a possibility of a simultaneous failure to achieve all four main policy objectives: adequate economic growth, full employment, a satisfactory balance of payments, and reasonable, stable prices." All these indicators were unfavourable: Unemployment was rising, inflation was rising, the balance of payments was in deficit, and growth was stagnant. The CBI, in the same month, February 1974, after surveying the intentions of its members, concluded that it was the most pessimistic survey that it had ever produced.

Now, the underlying trends were unfavourable, but added to that was the worsening position of the economy thanks to a short-term factor, the four-fold rise in oil prices following the Middle East War between the Arab States and Israel, the so-called Yom Kippur War in October 1973. Because the Arab oil-producing states decided to restrict the supply of oil and to raise prices in retaliation for the West's alleged support of Israel in that war, though even before the war, it is fair to say there had been a rise in world commodity prices and in the price of oil.

Now, if that was not bad enough, the defeat of the Heath Government on the issue of a statutory incomes policy, which the miners had resisted, increased the inflationary pressures because a new government would not be able to institute a statutory incomes policy, and in particular a Labour Government, which was so close to the trade unions, could not institute a policy which the unions opposed.

All this led both to a boom and a slump, and people thought, until then, the two could not exist at the same time, and this boom and slump were called stagflation. It was something totally new because the effect of the oil price rise was inflationary, obviously, it raised costs, but it was also deflationary because Britain needed, along with other industrial countries, to shift resources into exports to pay for higher-priced oil, and that was the situation that confronted the new Labour Government, returned rather unexpectedly I think.

They inherited a rate of inflation which was 12% and rising, a balance of payments deficit averaging £400 million in the first quarter of 1974, no growth at all in the last quarter of 1973, and rising unemployment – stagflation, which, as the new Labour Chancellor, Denis Healey, said traditional economists regarded as a contradiction in terms, both a boom and a slump at the same time.

Now, Denis Healey, the Chancellor in this new Government, who died recently, was the dominant figure in Labour's economic policy and in the story I am about to tell. Some of you may think he is the hero of the story, others may think he is the villain – that is for you to judge. Perhaps he was both hero and villain.

The new Government, as I said, was divided ideologically but really had no idea what to do in these quite unprecedented circumstances, unfamiliar and unprecedented, and they were told by the Permanent Secretary of the Treasury, perhaps not very helpfully, that the economy was now in such uncharted territory that the Treasury model might well not be a reliable guide as to what was going to happen.

In opposition, the Labour Party, or in particular the left wing, fearing another betrayal of socialism, had committed the next government to higher public expenditure on the social services and on the Health Service, and those commitments were in the Labour Party's Election Manifesto, so they had to be met as well. And then there was the problem of what to do about the trade unions after the defeat of the Heath Government and its so-called confrontation with the miners.

Now, until 1972, there had been a constraint on wage demands, which had been the fixed exchange rate in the British economy, because you would always say that, if the economy got out of hand, the pound would have to be devalued, but in 1972, the Conservatives had floated the pound, and that removed one discipline from the economy because it meant that you could meet high wage demands simply by allowing the pound to depreciate. The great danger with the floating rate would be that the rate would float downwards, further worsening the economic situation by increasing the cost of imports and so increasing the cost of living.

But there was a further problem with the floating pound because, at that time, Sterling was still a reserved currency, indeed the world's second reserve currency after the dollar, and other countries and individuals were, for the time being, happy to put their reserves into Sterling, and particularly those countries, primarily, but not only, the Arab States, which had done so well from the rise of the price of oil, had to find somewhere to put their surplus cash, and many of them decided to put it in London. Now, the problem with that is that if they lost confidence in the British economy and decided to withdraw the money from London, the economy in Britain would be in very serious trouble, so that increased financial and economic instability that the rate of Sterling depended, to a large extent, upon short-term deposits in the City of London.

These problems were so serious that the Foreign Secretary in the new Government, who was James Callaghan, who later became Prime Minister, told the Cabinet in the Autumn of 1974 that, whilst shaving in the morning, he felt that if he were a young man, he would emigrate, but he said, over breakfast, he could not think of any country he would prefer to go to and so he stayed. He later said that remark was intended as a joke.

Ministers took some time, I think, to appreciate the economic crisis, perhaps understandably, and one Minister in the new Government, Edmund Dell, who was Paymaster General and then President of the Board of Trade, he said that some ministers seemed unconscious of the economic crisis that had struck the country - "Their attitude resembled that of the characters in Jane Austin's novels who carried on their lives undisturbed by the Napoleonic Wars."

Now, the Government could have said the crisis was so serious that any improvements would have to be postponed. They could have made an appeal on the basis of, as it were, blood, sweat and tears – postpone improvements until we have restored stability. They did not do that. They said there was a crisis, that things were difficult, but that nevertheless, there could be business as usual. We do not know how the voters would have responded to a "blood, sweat and tears" approach because it was not tried, but it might have worked. The response of the British Government was different to that of most industrial countries to this crisis, because most industrial countries decided to restrict their economy, to accept a reduction in the standard of living, to deflate, and cut public spending, and that was roughly the kind of policy followed in recent years by George Osborne after 2010. But Britain, together with Italy, was the only country to adopt a different approach. The Labour Government said, with unemployment rising, it would be wrong to adopt policies which would raise it still further and restrict the economy. Governments then lived in a different world from the world they live in today. They lived in what you might call a Keynesian world, or perhaps what was caricatured as a Keynesian world, where economic problems could be resolved without too much pain, that there was less scepticism towards state action than there is today, and it was believed that governments could easily influence prices, wages, and the cost of living, through direct action through government controls.

Admittedly, those controls had not worked under Heath, the Statutory Incomes Policy, but the Labour Government had a different approach. It had what it said was an agreement with the trade unions called the Social Contract, and what that meant was that the Labour Government would repeal the legal restrictions on the trade unions introduced by Heath, in particular the Industrial Relations Act, and adopt a series of policies to control the cost of living directly – food subsidies, price controls, and controls on council house rents – and this would increase what Labour politicians called "the social wage", and in return, noticing this increase in the social wage, the trade unions would voluntarily agree to wage restraint. Michael Foot in particular, who was Employment Secretary in 1974, he said if one created the right social climate, the trade unions would respond.

The policy of the Social Contract was somewhat ambiguous, and for that very reason perhaps, attracted the agreement of both left and right in the Labour Party. The right said it meant the unions would restrain wages. The trade unions and the Labour left regarded the Social Contract as making for expansion over the economy, steadily rising wages, leading to a shift of power to the working classes. But what they agreed upon, left and right in the Labour Party in 1974, was the Social Contract precluded restrictionist policies which would increase unemployment, so it required increases in public spending, which in the end proved unsustainable. But, in any case, the Labour Government elected in March 1974 was a minority government and there would be a second election shortly. It could hardly go to the country, so it thought, on a policy of restrictions.

The Conservative Government under Heath had sought to deal with the crisis, which it saw as short-term, by borrowing, and this policy was inherited by the Labour Party, which decided to continue it by 1974, so the Government in Britain decided to meet the crisis by borrowing, not by restricting the economy. Healey said, in 1974, "Borrowing is more sensible in economic and human terms than trying to cut imports by massive deflation." At the time, paradoxically, the IMF, the International Monetary Fund, supported that argument because they said, if every country restricted their economy, they would turn the depression into a worldwide slump, as we had seen in the 1930s, but still, most countries did not follow that advice – they did restrict their economies, and that proved to be a sounder basis for increasing employment and growth once the public finances had been restored, and that again is what George Osborne did in 2010.

In the 1970s, Britain and Italy were the only industrial countries which sought to meet the crisis by maintaining income and demand rather than deflating. They did not wish to accept the loss in national income and the fall in the standard of living caused by the rise in the price of oil. By 1978, the Government could argue, North Sea oil would be flowing and Britain would become a net exporter of oil, and then Britain would become a strong economy and people would be only too anxious to lend us money. If only we could hold on until then, everything would turn out right. But the difficulty with this argument is that Britain was exceptionally exposed to the confidence of the international markets because of its high rate of inflation and unfavourable balance of payments position, and there was no reason to believe that other countries would indefinitely contribute funds to the British economy to enable us to enjoy an artificially high standard of living.

Significantly, Britain and Italy, the only two countries which tried to meet the economic crisis by borrowing, were also the only two countries which subsequently had to seek assistance from the IMF in the following two years, and because Britain was attempting to expand her economy while others were restricting theirs, she was bound to run into economic difficulties, and so it proved…

Now, in Healey's first Budget, in March 1974, facing another election in a few months, he increased pensions and food subsidies and subsidised rents. Public spending had risen in real terms by 8.5% in the last year of the Conservative Government. They were to rise in real terms by over 12% in Labour's first year, although GDP showed a small absolute decline, and to that increase in real terms had to be added the increase in money terms because of accelerating inflation, and in 1974, the Retail Price Index was up by 16%.

Now, how was this to be financed? In part, by increases in employers' national insurance contributions and increases in income tax, but primarily of borrowing, by two forms in borrowing: first, an increase in the Public Sector Borrowing Requirement, which meant a deficit; but secondly, by borrowing from abroad, primarily from the oil-producing countries. These countries, as I said, had large surpluses and were happy to lend that money to London and hold some of their surplus funds in Sterling, but they were, as I said, very volatile.

The truth is that the length and depth of the recession were not foreseen, and later in 1974, there were even further increases in central government spending, and this spending, again, was on subsidies on housing, transport, food and school meals. Inflation was rising throughout the year, even though, by this time, commodity prices were beginning to fall, and even worse, by the end of the year, it was apparent that fewer than half of the pay settlements were within the voluntary guidelines that had been agreed by the Government and the TUC as part of the Social Contract. Many trade unions were taking no account of the so-called increase in the social wage, which Healey said amounted to £1,000 a year for every member of the working population. To make it worse, the Government, which had predicted a 3% rate of growth, by the end of 1974, it was clear that growth was nowhere near that level, and by the end of 1974, Treasury officials felt that a new approach was needed, and in December, a committee of the Permanent Secretaries of the Economic Departments said the Social Contract was not working, that the going rate for wage settlements was well over 20%, with some wage settlements approaching 30%. The Chief Secretary of the Treasury, Joel Barnett, later said that "To my mind, the only give and take in the Social Contract was that the Government gave and the unions took." This was an exaggeration, but an understandable one.

Now, the committee of officials then went on to say the Government could not continue to finance the deficit by borrowing. Taxes had to be raised and public expenditure cut, even though this would mean that unemployment would increase. If existing policies continued, the committee warned, "...there is a very serious, some would say overwhelming, risk that an external crisis will hit us, and when it does, we are likely to experience an attack on Sterling. In this situation, we shall not have the foreign exchange reserves to defend the rate." And that was what happened in 1976…

But if 1974 was, you might say, a year of unreality, 1975 proved a year of fundamental policy changes and there were no fewer than four absolutely fundamental policy changes which I think serve to divide the post-1974 period in post-War history from the pre-1975 period.

The first fundamental change was an abandonment of the commitment to full employment, so as to give priority to the conquest of inflation. This change was announced in Healey's 1975 Budget. He said that although unemployment was rising, "I do not believe that it would be wise to put unemployment as the central problem." He said he could not increase demand anymore because he could no longer finance the balance of payments deficit by borrowing, so he decided to shift resources from domestic demand to the balance of payments, even if this meant a further rise in unemployment. That went against traditional Keynesian theory, which, when faced with rising unemployment, said there should be a fiscal stimulus to the economy. Healey was proposing the opposite. This fundamental change, it is worth emphasising, came about not under Margaret Thatcher or her Government from 1979, but under a Labour Government, with Healey as Chancellor, a Government of the left. Under Labour, unemployment reached a peak of 1.5 million, and it has not fallen below a million since – it has often been higher. This heralded a move to permanently higher levels of unemployment in the 1980s, which peaked in 1982 at 13% of the labour force. Since the 1970s, it has averaged 7%. Now, at a time of supposedly low unemployment, just over 5%, higher than at any time before the mid-1970s, so you can divide this period in terms of levels of unemployment.

The second major change occurred in Healey's second Budget of the year, in July, when he imposed cash limits to policy programmes. Previously, a programme had been agreed, and if inflation had made the made the programme more expensive, the money had been found, so the programmes had been effectively inflation-proof. This was no longer to be the case, except for Social Security cash payments, where the Government obviously had to meet whatever was required for the sick, disabled, unemployed and pensioners, but all other programmes were to be fixed in cash terms, not in real terms.

The third change was a reduction in public spending, and indeed a questioning of the belief, very strong in Labour circles up to that time, that a growth in public spending was necessarily a good thing - was it really as beneficial as had previously been thought? Now, according to Tony Benn's Diaries, in Cabinet in 1975, Denis Healey was arguing that public expenditure cuts would not necessarily be unpopular. He said: "At the Labour Clubs, you will find there is an awful lot of support for the policy of cutting public expenditure. They will all tell you about Paddy Murphy up the street who has got 18 children, has not worked for years, lives on unemployment benefit, has a colour television, and goes to Majorca for his holidays." Plus a change… So, there was a move towards reducing public spending and the size of the State.

The fourth and final major change was the introduction of a voluntary incomes policy in July 1975, and this incomes policy accepted that in consequence of the oil prices, the standard of living would have to fall, and the voluntary incomes policy implied a cut in living standards of around 2.5% over the year.

Now, none of this was popular, and in September 1975, Healey was voted off the Labour Party's National Executive. Two leading left-wingers in the Party expressed their disappointment in their Diaries. Tony Benn said, "I despair of the Labour Government as a force for transformation." Barbara Castle said, "I see no reason for the existence of a Labour Government." But despite that, there were to be further cuts in public expenditure in November.

So, all these fundamental changes, let me again emphasise, came before Margaret Thatcher in 1979, and before the IMF came in in 1976.

The new policies did have some success, and the summer of 1975 proved a watershed as regards wage settlements. The TUC persuaded the unions to accept the Government's guidelines for two years after 1975, and from then on, the annual rate of inflation fell to around 10%, though some argued it would have fallen anyway. But despite this, if 1975 was the year of fundamental change, 1976 was the year in which the wheels fell off the Government's policies because the improvement in the economy did not prove sufficient to restore confidence in Sterling, nor in the underlying economic position.

The oil-producing countries were now seeking to place their surplus funds in other financial centres besides Britain and many wanted to invest in property elsewhere in the world. There was a fear that, although the real economy was improving, there was a worry that Sterling would depreciate, and the trouble was that when a currency is felt to be weak and there seemed to be deep underlying economic problems, markets will put the worst construction on all news, and in particular, it was felt that this new economic policy of retrenchment did not have full Labour Party support, and that feeling was strengthened in February 1976, when Healey produced a public expenditure White Paper saying that there should be a further reduction in the share of resources taken by public expenditure and that resources should then be moved to the balance of payments. There was a vote on that in the House of Commons in March 1976 and enough Labour rebels abstained on the vital vote so that the Government was defeated, and the defeat had to be reversed by a vote of confidence the next day.

Healey reacted to this speech with great anger. He had an ebullient rough manner and enjoyed being rude to people, which was not always appreciated by others. Gerald Barnett, his Chief Secretary of the Treasury, said at one meeting in the Treasury, Healey ended the meeting by saying, "Let me make sure that I have indeed insulted everyone around this table." Healey shouted at the left-wing rebels in the Commons that they were "out of their tiny little Chinese minds". The Chinese Embassy complained, and Healey had to make an apology… There was even worse: Healey and the left began swearing at each other in the House of Commons – it was not then televised, but in the full hearing of other Members, and Healey always said that they had a very complex love life in the Labour Party. He said, in his Memoirs, he said feelings were at boiling point on both sides. "As I returned to the Chamber from the voting lobby, one of the rebels used demotic language to cast aspersions on my paternity, so I praised his virility in similar language, several times."

Now, five days after this disaster, Harold Wilson resigned, and he had not told Healey that he would resign, although he had told James Callaghan, and of course Healey's chances of the leadership, whatever they were, were not improved by this episode, and indeed, Callaghan became Prime Minister.

With Callaghan as Prime Minister, there were further reductions in public spending, both in a budget in April and another budget in July, and, in June 1976, the Government was forced to borrow to prevent a further depreciation of Sterling and loss of reserves. It gained credits of $5.3 billion from the group of 10 industrial nations for three months, with provision for renewal for just one three-month term after that, and the Government could not get borrowing on any other terms. People did not believe in the progress of the British economy. This meant the loan would run out on 7th December 1976, and if, at that time, it could not be repaid, the Government would have to go to the IMF.

The pound continued to fall, and on 28th September 1976, just as Labour's Annual Conference was beginning, the pound suffered its largest one-day fall in value since Sterling had been floated in 1972. There had now been eight budgets since Healey had become Chancellor in March 1974, and the pound had fallen from 2.30 to the dollar, when Healey had become Chancellor, to 1.67, and since Callaghan had become Prime Minister in April, the pound had fallen by nearly 20%, larger than the devaluations of 1949 and 1967.

The selling of Sterling was reaching dangerous levels, and Healey was told of this news as he was going to London Airport for a meeting of Commonwealth Finance Ministers in Hong Kong, to be followed by a meeting of the IMF at Manila, at which Britain's application for a long-term loan from the IMF would be considered. Now, Healey decided not to travel to these meetings but to go back to London and then to talk to the Labour Party Conference which was then in session. He told them he was applying to the IMF for a loan, and that was very unusual at that time for a developed country - it was mostly developing countries which applied for loans – and that the application was for $3.9 billion, at that time the largest sum ever requested at the IMF. Healey told the Labour Party Conference, melodramatically, that he had come "from the battlefront", that he would seek a loan from the IMF so he could continue with existing policies. He received a mixed reception from the Party Conference, as you can imagine.

[Recording plays]

"I am going to negotiate with the IMF on the basis of our existing policies, not changes in policies, and I need your support to do it, but when I say "existing policies", I mean things we don't like as well as things we do like. It means sticking to the very painful cuts in public expenditure on which the Government has already decided. It means sticking to a pay policy which enables us, [as] the TUC resolved a week or two ago, to continue the attack on inflation. It means seeing that the increase in our output which has now begun goes not into public or private spending but into exports or investments. That's what it means and that's what I'm asking for. That's what I am going to negotiate for, and I ask this Conference to support me in my task! [Applause]"

Now, the previous day, Prime Minister James Callaghan had put a further nail in the coffin of Labour's aspirations and of the Keynesian consensus. He told the Labour Conference that the country for too long, perhaps since the War, had been living on borrowed time, borrowed ideas, and borrowed money. He said the days when full employment could be secured by a stroke of the Government's pen were over, if these days ever existed. Britain's problems, he said, were caused by paying ourselves more than the value of what we were producing, and spending one's way out of recession simply injected inflation into the economy and then the average level of unemployment rose.

[Recording plays]

"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 insofar as it ever did exist, it only worked on each occasion since the War by injecting a bigger dose of inflation into the economy on every occasion, followed by a higher level of unemployment as the next step."

"And if the candour of the last unelected Labour Prime Minister will not do, listen to what the current unelected Labour Prime Minister used to say! We have learnt from past mistakes that you cannot spend your way out of a recession. Well, it turns out he has forgotten past mistakes, and now he is condemned to repeat them."

There are of course echoes in what Callaghan has said in contemporary debates.

It was seen, in 1976, as a watershed moment, that speech, but it really did no more than confirming for public consumption a policy shift that had already been made by the Labour Government. But the difficulty was that the speech was interpreted abroad as evidence that the Labour Government would alter its policies in the direction of further expenditure cuts, whereas Healey said he was going to negotiate on the basis of existing policies, but it was those existing policies that had lacked the confidence of the international financial community.

Now, the IMF was, at that time, and perhaps it still is, I do not know, but at that time, it was dominated by the Americans and the Germans, who supplied most of the funds, and little could be done without their support. The Government had first hoped that the Americans and the Germans would support an unconditional loan to Britain, but they, not unnaturally, wanted assurances they would get their money back, and also they would not be asked again to pour good money after bad.

Britain had of course borrowed money from the US in 1945 when Lend-Lease had run out, and, as those who attended my last lecture on Suez may remember, after the failure of Suez, they borrowed money from America again to prevent a run on the pound. Now, it was seeking further charitable help from the Americans. Indeed, the British at this time, I think, perhaps still, tended to perceive America as a giant charitable institution which would always be willing to bail Britain out, and that perception was aided by the good personal relations between Callaghan and President Ford, even though Ford headed a government of the right, a Republican Administration, which was not particularly sympathetic to what it saw as an attempt to build socialism in Britain on borrowed money.

The American Treasury Secretary, William Simon, had said in June 1976 that "Lenders will become increasingly reluctant to finance expanding current account deficits unless borrowing nations make fundamental changes in their domestic economic policies." In his Memoirs, Healey says that William Simon was "far to the right of Genghis Khan, but of course, one never likes one's bank manager", and the trouble with the Americans was they had the eccentric idea that American economic policy should be decided on the basis of America's national interest and not on the basis of Britain's national interest. The British were saying our economy is sound – just lend us the money, and as if you were going to your bank manager and saying "My finances are perfectly sound – please lend me the money", but unfortunately, it is not for the borrower to decide the terms on which he will graciously accept a loan or an overdraft. It is for the person who lends you the money to decide. At the Manila Conference of the IMF, Arthur Burns, who was the Chairman of the Fed in America, issues a diatribe against the Labour Government, saying it must abandon what he called "this nationalisation nonsense" and give the people some incentives. It had to reduce its awful deficit, satisfy the world banks, and he said "Denis Healey does not understand this". But in any case, even if the Ford Administration had been more willing to help, it was in the middle of a presidential election campaign, and in November 1976, Ford was defeated by Jimmy Carter, so he became the lame duck President, so there was not much the Americans could do.

At first sight, things appeared rather better in Germany because Helmut Schmidt, the Chancellor, who, like Healey, died recently, he was a social democrat, albeit much to the right of the British Labour Party, and he had a very warm relationship with Callaghan and Healey. Schmidt was sympathetic, but he could not help because he had no lawful authority to commit resources without the consent of German's independent central bank, the Bundesbank. The view of the Bundesbank, and indeed most Germans, was that Germany had put her economy in order after the oil crisis, through methods of financial discipline, and that Britain should do the same. In any case, Schmidt, like Ford, was facing an election at the end of the year and was unwilling to follow policies which German voters would see as profligate and inflationary. So, friendship proved an inadequate basis on which to expect help. The money that was to be loaned to Britain came, after all, from American and German taxpayers, and the prime responsibility of the American and the German Governments were to their own taxpayers and not to the British Government.

Treasury officials reported back to London the IMF's view that we had run out of time. Our failure to take sufficient action on the Public Sector Borrowing Requirement and monetary policy earlier meant that our options were now much more limited and the action needed now was more drastic. The margin of credibility had narrowed. There needed to be what the officials called "a change in fiscal stance". The IMF said Britain's problems were not due only to the oil price rise but deep-seated and longstanding economic weaknesses and antiquated industrial structure, high marginal tax rates, low rate of capital formation, poor trade union and management practices, and that meant the British economy could not cope with temporary crises such as the oil crisis and a run on the pound.

Healey had told the Labour Party Conference he would negotiate with the IMF on the basis of existing policies, and that was true to the extent that public spending cuts, monetary targets, and cash limits had all been introduced before December 1976, but it was not true if it meant there was to be no intensification of these policies. For the loan to be obtained, there had to be such intensification.

The IMF demanded further spending cuts and a new macroeconomic and budgetary stance, secondly, a new policy on the exchange rate, and thirdly, financial performance targets. The main political battle was over the cuts, and the Labour Government was in danger of being trapped between the demands of the IMF for cuts and the unwillingness of the Cabinet, the Party and the trade unions to accept them. The IMF's original terms were for £3 billion further cuts in 1977/8 and £4 billion in 1978/9, but after complex negotiations, Healey reached agreement on the basis of a further £1 billion of cuts in the next financial year and £1.5 billion in the year following, less than the IMF wanted. Healey also promised to abolish food subsidies and the other price controls imposed in 1974 and he agreed to strict monetary targets and cash limits on public expenditure, to be monitored by the IMF. So, the reduction of unemployment was put even further into the background, but in return for that, we secured the IMF loan and that stopped the slide on Sterling.

The main problem had been how to get the left in the Cabinet to agree. The left wanted a programme of import controls to protect the balance of payments and avoid having to restrict the economy. The difficulty with that policy would be that it would be against the rules of the General Agreement on Tariffs & Trade, GATT, and also the European Economic Community, the predecessor of the European Union, which we had joined in 1973, though Benn and Foot had been against our joining. In addition, there was a danger that import controls would lead to retaliation so they would not yield any lasting gains. But fundamentally, the IMF would not accept import controls as a basis for a loan, and the general view of the Cabinet was, if they could not get the loan, they were sunk, so that was excluded.

But there was a second alternative proposed by what one might call the Keynesian right in the Labour Party, led by Anthony Crossland, Foreign Secretary, and Shirley Williams, the Education Secretary. They argued that, with unemployment at 1.5 million, there was no case for further cuts. The spare capacity was available to increase exports.

Now, Callaghan, as Prime Minister, said that the Labour Party must avoid, at all costs, another 1931, when the Party had split and the Government had broken up over public spending cuts, and in particular cuts in unemployment benefit. Tony Benn circulated the Cabinet papers from 1931 as a warning of what could happen. But Callaghan showed great political skill in allowing dissenting Ministers full opportunity to put their case. There was a detailed discussion in Cabinet, from nine Cabinet meetings, before agreement was reached on a new economic package.

In the end, Crossland withdrew his opposition, saying the Prime Minister could not be defeated on a matter of this importance, and in fact, Callaghan had told Crossland, though no one else in the Cabinet, that he would resign if the terms were not accepted.

Acceptance of these terms did not indicate a reversal of policy but an intensification of the policy adopted first in 1975, cuts in public spending, a further bite of the cherry. Paradoxically, the IMF loan gave the seal of international approval to the Labour Government's policy, and this, again paradoxically, enabled the Government gently to inflate the economy in 1977 as conditions improved and confidence was restored. This was a great triumph for Callaghan and Healey to persuade the Cabinet to agree on the programme, persuade the IMF to scale down its original demands, persuade the trade unions to agree, with no split in the Party, no repetition of 1931.

As it turned out, the Treasury forecasts of the Public Sector Borrowing Requirement proved mistaken, and public borrowing turned out to be far less than had been forecast and predicted. The Treasury had predicted that for 1976/7 the Public Sector Borrowing Requirement would be £10.5 billion. In fact, it turned out to be $8.5 billion. This was mainly due to the introduction of cash limit, whose effects had been underestimated. Healey was furious, and in his Memoirs, he said an economist was "a man who, when you ask him for a telephone number, gives you an estimate".

The economy improved rapidly in 1977. Visible exports were heavily up and the balance of payments was almost in equilibrium. Growth was back to 3%. Unemployment was falling. Inflation was below 8%. It was natural for people to argue that, if the forecast had been right and the true economic situation in Britain had been presented to the outside world, the loan would have been unnecessary. I am not sure that argument is acceptable because it ignores the power and irrationality of the markets. Whatever the realities, if the markets in a globalised world do not have confidence, measures will have to be taken. The trouble was, the measures originally taken in 1974, which involved increasing borrowing, together with increases in public spending and a failure to control wage demands, together with the long-term chronic weaknesses of the British economy, a history of poor economic and industrial performance, had raised deep-seated doubts in the minds of holders of Sterling. Now, it was easy for critics to insult the holders of Sterling as speculators. Harold Wilson had famously called them "the gnomes of Zurich". But the gnomes were bad only when they were selling Sterling, not when they were buying it and enabling Britain to live on borrowing, and Britain had relied on the wicked gnomes in 1974 to maintain public spending.

But whatever you think about whether the agreement with the IMF was needed or not, it undoubtedly enabled the Labour Government to continue. By 1978, the Government was in calmer waters, and perhaps a General Election in the autumn of that year would have kept Labour in power, but Callaghan postponed it, and the public sector strikes of the ensuing Winter of Discontent ruined the Government and led to 18 years of Conservative rule, so the seeming triumph of 1976 turned to dust and ashes. Labour was defeated not so much by the Conservatives as by its own industrial wing, the trade union wing of the Labour movement, by the public sector unions. One of Callaghan's advisors said: "It was the public sector unions that brought Margaret Thatcher to power, and she then proceeded to thank them in her own individual way."

Healey was to spend his years in retirement recalling the past and claiming that if only the Election had been called in autumn 1978, he would, some years later, have been forming his third or fourth Administration, with the aid and benefits from North Sea oil. Who knows?

Now, the verdict of most historians is that this Government's policies had failed, but then most historians also think the Heath Government before it had failed. Perhaps the reason they are both seen to have failed lay less in failings of personalities, contingencies, or ideological failures than in another reason, that they were seeking to govern in a period of transition, in which the familiar political and economic landmarks were disappearing, and one paradigm was being replaced by another. Wilson and Callaghan, as well as Heath, had all been governing in the twilight of the post-War settlement. Issues that seemed to have been closed were now being re-opened. New questions were being asked.

First, as I said, full employment – could the State really, as was claimed, through intelligent macroeconomic policy, secure full employment and price stability using Keynesian methods? Now, in an important book written in 1956 by Anthony Crossland called "The Future of Socialism", a book which influenced a generation of thinkers on the left, Crossland said: "Acting mainly through the Budget, although with the aid of other instruments, Government can exert any influence it likes on income distribution and it can also determine, within broad limits, the division of total output between consumption, investment, exports and social expenditure." Was that still true? By the 1970s, it seemed the traditional levers were no longer working effectively.

Secondly, the State should, in Crossland's view, use its ability to control the economy to redistribute income. Crossland said, in "The Future of Socialism": "A Labour Government should commit itself to a definite increase in the proportion of national resources devoted to social welfare." But in 1976, the argument that the economic crisis should be met by a rise in taxation rather than cuts in public services was rapidly dismissed by Callaghan and Healey, and pressed even on the left in a somewhat lukewarm manner. Later, after its unexpected defeat in the 1992 Election, the Labour Party drew the lesson, whether rightly or wrongly, that electors, whatever they told the opinion pollsters, would not, in the privacy of the voting booth, support a party which proposed higher taxes to finance the public services, so improvements in the public services would have to be found in other ways.

Thirdly, should the trade unions still be given such an important consultative role in Government, which was an inevitable consequence of incomes policies and had really begun in 1940 when Ernest Bevin had become Minister of Labour. Were incomes policies really of much use in controlling inflation? They were introduced by every Government between Macmillan in 1962 and Callaghan in 1976, but they were not to be introduced again after the Winter of Discontent.

In his Memoirs, Healey says: "I abandoned Keynesianism in 1975. His theories had two important weaknesses when applied in post-War Britain: they ignored the economic impact of social institutions, particularly the trade unions – in fact, Keynesian policies were unlikely to work in Britain without strict control of incomes; and they ignored the outside world."

It is worth elaborating on these two points. The first is the role of trade unions in a full employment economy. Now, when Keynes had published his general theory in 1936, Britain was still in depression and the problem did not arise. During the War, Keynes and others were well aware of the danger of inflation, but hoped it could be dealt with by trade unions showing a sense of responsibility and acting for the common good – all should pull together. That was made more difficult after the War by the growth of a large nationalised sector, for a nationalised industry, unlike a private one, could never go out of business. It could never say the money was not available to finance wage claims – it was always there. It could be obtained through further taxation or borrowing. So, if a nationalised industry refused to increase wages, that was a political, not an economic, decision and could perhaps be reversed by strike action. Today, interestingly enough, the threats to industrial peace lie in two nationalised industries, the National Health Service and the London Underground.

Above all, the Keynesian proposals presumed social cohesion, that everyone thought as one nation, and when Edward Heath introduced his Statutory Incomes Policies, he said, "Think nationally. Think of the nation as a whole. Think of these proposals as members of the society that can only beat rising prices if it acts together as one nation." Now, that might have worked in the War, it might have worked under Attlee and Churchill in the immediate post-War years, but by the 1970s, few took much notice because society was becoming more fluid, there was less loyalty to the group or the tribe. Even if the trade unions were sympathetic to requests made by the Labour Government, and many of them were, they were losing authority over their members. In the 1960s and 1970s, there was a rebellion against authority, deference was being undermined, and the trade unions were not immune to that. Trade union members were ignoring their leaders if they thought they could get more money through unofficial strikes. The success of incomes policy depended on the authority of trade union leaders, perhaps also on the fear of unemployment, which the post-War commitment to full employment had removed.

The second weakness in the Keynesian analysis to which Healey drew attention in his Memoirs was that the world was becoming increasingly globalised, so a policy that might be intellectually defensible would not work in a world where the international markets made an unfavourable judgement. A government takes risks when it flies in the face of market opinion, even if that opinion is believed to be misguided. Now, Crossland had believed that social democrats could pursue policies of their choice, largely untrammelled by foreign opinion. In the 1950s, that seemed to make good sense because Britain was a sheltered economy, protected by tariffs and exchange controls, but by the 1970s, the progress of national economies was becoming inextricably bound up with the international economy and the pressures of the global market. Governments could no longer adopt national macroeconomic policies aimed at boosting demand without risking punishment by the markets in the form of higher interest rates and falling currency.

Tony Blair showed he understood this when, in 1995, he said: "We must recognise that the United Kingdom is situated in the middle of a global market for capital, a market which is less subject to regulation today than for several decades. An expansionary fiscal or monetary policy that is at odds with other economies in Europe will not be sustained for very long. To that extent, the room for manoeuvre of any government in Britain is already heavily circumscribed."

Now, in addition to these general constraints, Britain, as a member of the European Community, was subject to further constraints. Now, the European Community had not come into existence when Crossland wrote "The Future of Socialism" in 1956, and the Leader of the Labour Party at the time, Hugh Gaitskell, was, with some of his leading colleagues, such as Douglas Jay and Patrick Gordon-Walker, positively hostile to it, partly on the grounds that membership would inhibit the policies of economic planning to which a democratic government should be committed. But by 1976, Britain was a member of the European Community. We joined in 1973, and membership had been confirmed by a referendum in 1975, and this made Britain subject to even more rules, for example on free trade, which would make it more difficult to introduce socialist policies.

So, all this made it more difficult to see how the social democratic value of redistribution could possibly be attained, in particular when studies showed that globalisation had the consequence of increasing inequalities, even within the single state, let alone between states.

For much of the 20th Century, the Labour Party had been sustained by the belief that socialism was somehow in tune with the trends of history, that the advance of socialist or social democracy was in some sense guaranteed by history, by what Sidney Webb had called "the inevitability of gradualness". Society, so it was believed, was moving in a collectivist direction. A Conservative Government, no doubt, would continue to be elected from time to time, but it would administer a dispensation shaped by Labour, and that had been the case possibly with the Churchill and Macmillan Governments in the 1950s, but if the Conservatives tried to go further, if they had tried to roll back the state, they would be repudiated by the electorate because the social gains of the Attlee Government could only be maintained through state action, and voters would punish any government which sought to undermine them. It was for this reason that Crossland believed that these gains – full employment, the welfare state, sharply progressive taxation, and recognition of the claims of organised labour – were permanent and immune to challenge from the right. Now, the advent of Margaret Thatcher to power of course changed all that because she conceived her task not merely as one of containing the advances made by Labour but of reversing them, and, dismissed at first by many on the left as an aberration, it soon became apparent that she was engaged in reversing many of the gains of social democrats. In 1981, the Marxist historian Eric Hobsbawm, wrote a famous pamphlet called "The Forward March of Labour Halted". So the Labour Party was forced to adapt its doctrines to conditions that it had not before envisaged. It now seemed that social democracy, far from being guaranteed by history, was being repudiated by it, and in 1994, Tony Blair produced the doctrines of New Labour, a social democratic philosophy capable of meeting the new conditions of a globalised world.

In 1974, Tony Benn had said the crisis should not be used to prop up an ailing capitalist system but should be the basis for a forward march into socialism. "We should all be socialists now," he said. But after the 1974-9 Labour Government, the Party could not again come into power for another 18 years, when it succeeded in convincing the electorate, under Tony Blair, that none of us are socialists now. That, I would argue, is the fundamental significance of the IMF crisis in 1976.