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*25. 10. 78*

*cc PSS  
PSM  
Dep. Sec*

*Mr. Heanlip*

*Mr. O'Leary*

*Mr. O'Callaghan*

*A. K...*

*9/10*

23 October 1978

Secretary  
Department of Foreign Affairs

Attention Mr Hugh Swift

Summary

Successful management of the economy and harmonious working relations with the unions are the Government's best electoral cards. The unions' rejection of the Government's pay policy faces Mr Callaghan with serious problems on both counts. But he still has room to manoeuvre to try to patch up a working arrangement with the unions that will maintain the Government's economic and political credibility. He is helped by the internal divisions in the Conservative party on economic policy, sharply identified now again by Mr Heath's interventions. Britain's decision on EMS has been complicated by the present uncertainty and political debate surrounding the Government's economic policy.

With the annual party conferences now over, the next important dates on the political calendar are the two by-elections on October 26th (at Berwick and East Lothian and Pontefract and Castleford) and the Queen's Speech following the opening of Parliament on 1st November.

Though they have not yet announced their intentions, the Nationalists are at present expected not to vote to bring down the Government on the Queen's Speech. Labour seem likely to hold the Pontefract seat in this week's by-elections but will have to do very well to keep the seat at Berwick.

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Pay Policy and  
the Unions

Pay, prices and unemployment remain key factors which will influence the result of the next general election. The events of recent weeks, particularly the substantial vote against the Government's pay policy at the Labour Party Conference, the strike at Fords, and ensuing and anticipated claims from major unions well above the 5% norm, have been a serious setback for the Government. The improved results obtained during phase three, as relative Labour successes at recent by-elections show, have been recognised by the electorate. But now that an election has been deferred the difficulties inherent in implementation of phase four have begun to make themselves felt.

At Brighton in September, the TUC at their general Conference, anticipating an October election, kept their heads down on pay policy. Once the prospect of an immediate election disappeared, however, the flood-gates broke with a speed which the Prime Minister can hardly have anticipated as, indeed, he as much as admitted at Blackpool. The pace and force of union reactions against the pay policy are not the result simply of changes in the union leadership (though the Prime Minister's advisers are bitterly critical of the part so far played by Jack Jones' successor at the TGWU, Moss Evans) but reflect the strong pressures from shop-floor level against continuance of a pay norm into phase four.

The difficulties posed for the Government by these developments strike at the two key pillars of electoral appeal on which the Government is relying to win the next election. These are, firstly, that its economic policies and, particularly, its fight to bring about a steady reduction in the inflation rate, are working; and, secondly, that Labour can carry the unions with it in implementation of these policies as the Tories could not. These two claims, plus the Prime Minister's personal standing in the country,



compared with Mrs Thatcher's, are seen as the mainstay of Labour's prospects for re-election.

The effort is now underway to put together with the unions a framework of compromise which offers the prospect of holding the course of the economy at least within acceptable margins of that projected under the pay policy to date. The 5% norm has not been officially discarded nor would the Prime Minister easily consign it publicly to the waste paper basket without serious political damage. But the Government is now looking for ways of greater flexibility e.g. on fringe benefits, productivity deals, raising of minimum wage thresholds and, perhaps, stronger price control mechanisms (though official reaction to the unions' case on this is not yet forthcoming) which can allow negotiation of the various wage claims crowding in over the next few months to proceed with the minimum of confrontation and strikes. Control of inflation remains the key economic and political yardstick conditioning the Government's margin of manoeuvre.

Mr Callaghan has always made it clear that he wished to continue as close as possible to the end of his mandate. The decision to defer an October election was consistent with that aim. Put negatively, the Prime Minister would only have decided to go to the country in October if the polls had suggested a clear Labour majority, which they did not. It could still have been an option for the Prime Minister to call an election in November if the Queen's Speech were defeated. Recent events, however, seem to have stripped that option of its appeal. At Blackpool, Mr Callaghan said that if wage settlements were proceeding at an unacceptable level in terms of the battle against inflation, the Government would not hesitate to use further monetary constraints. But if the stage were arrived at where settlements were being reached at a rate certain to bring inflation into double figures next year and if



further monetary constraints were imposed in those circumstances with deflationary consequences and a rise in unemployment to be anticipated, the Government would be faced with the worst possible scenario in which to hold an election. This will be the Prime Minister's message for union leaders in the coming weeks as he tries to gain their influence for moderation in wage settlements.

The circumstances are not such that hard and fast agreements can be expected with the unions. The Government's hope seems to lie in some much looser form of phase three, which would have enough public identity as a "pay policy" to restore political credit and enough understanding on the practicalities to weigh against a rise in earnings seriously fuelling the inflation rate. On the Government's side, emphasis will be put on figures showing a steady rise in real disposable income over the past twelve months: on the common danger of inflation; on public support for the principle of pay control; and all this in awareness that the unions, for their part, while they have to react to pressures from the rank and file against pay norms, also have to take account of potential and actual conflicts in their own ranks between the "pure" free collective bargainers and the weaker sectors who fear for their prospects in a wages free for all.

The Prime Minister in Bonn last week, entering discussions on EMS and aware of international questioning of the Government's economic control in the light of recent events, professed himself ready to face down a hard winter. But the Government still has room for manoeuvre and the ingredients for a package of "understandings" public and private that would protect credibility politically and economically. Many City analysts and merchant bankers are understood to think such a package on the cards with projections, on this basis, of an average rise of around 10% in earnings for the phase four period.



Growth in money supply has been running within the 12% band and official forecasts are that the inflation rate will remain marginally below the present 7.8% at least until the spring. Apart from wage claims, overlag from the 14% average increase in earnings in phase three (even allowing for a productivity ingredient, well above the Government's 10% norm), trends in raw material prices and the strength of the pound (both favourable in the recent past) will affect further developments. The concentration of public debate on the current wage round has complicated an already difficult decision for the Government on EMS at a time when the anti-EEC tide is running more strongly than ever in the Labour Party and when the Tories under Mrs Thatcher see "Europeanism" in a much more distant perspective than party interest. The time span between now and the next election is so short that anything rocking the economic boat, however short term, spells danger for the Government. When the threat of such disturbance has a European flavour, as with EMS, the Prime Minister's problems have been all the more acute.

Pay Policy and  
the  
Conservatives

The differences on pay policy within the Conservative ranks were brought into the open at the Conservative Party Conference in Brighton by Mr Heath. After the Labour Party Conference and the defeat of the 5% norm there was much comment to the effect that the Government's economic policy was in practise, if not in theory, moving closer to that of the Conservatives. Mr Heath's intervention obliged the Conservative leadership to give a somewhat sharper definition to its economic policy than might otherwise have been the case and the Shadow Chancellor, Geoffrey Howe, and, more bluntly, Sir Keith Joseph and Mrs Thatcher herself, firmly dismissed the use of pay norms and called for "responsible" but free collective bargaining in the private sector with Government exercising strict monetary control and control



over public sector settlements. The Employment Shadow Secretary, Mr Prior, took a much more nuancé line, admitting in a radio interview that, effectively, a general rise in wage levels of no more than around 5% was probably necessary to hold down the rate of inflation. There is still, therefore, a marked division within the Conservative leadership on economic policy. The political impact of this division had perhaps, in the immediate, less striking public effect by virtue of the fact that the Government itself, while still nominally adhering strictly to its pay policy as originally set down with the 5% norm, is now obliged to both look for, and talk about, other levers of control including that of monetary constraints. But the division was quickly exploitable and the fact that Mr Heath seems determined to prevent its concealment and to insist publicly on the necessity of pay policy is, for the moment at least, of great importance and advantage to the Government. Whereas industry have been taking a critical line on Government intervention on pay in the private sector, now that Mr Heath has brought the Josephite line in Conservative thinking squarely into the open again, the "moderate" voice in industry is likewise emerging more clearly.

The next Session  
of Parliament

On the Westminster front, the Queen's Speech at the beginning of the next Session is the Government's first major hurdle. The Prime Minister's speech to the Labour Party at Blackpool foreshadowed much of the legislative programme likely to be set out in the Queen's Speech including Scottish and Welsh devolution referenda, worker participation, a Tenants Charter, and improvements in the National Health Service and control of schools. Increased Northern Ireland representation at Westminster is also expected to be included. The political challenge to the speech can be expected to concentrate on the issue



of economic policy and, particularly, unemployment. Traditionally, two amending motions are put to the vote.

A note is attached giving the present party breakdown at Westminster. At present the likelihood is that the Government will carry the vote on the Queen's Speech aided by (at least) abstention from the Scottish and Welsh Nationalists.

Even if all the Unionist votes go against the Government, (and the Liberals stick to their intention to vote against) the latter cannot be defeated unless a number of Nationalists also oppose. The SNP have been split between those who think the party will suffer badly from allying, in effect, with Labour and letting the Government off the electoral "hook" and those who hold that the establishment of a Scottish assembly at any cost is the party's correct long-term strategy. Recent by-elections and polls have shown a marked decline in the SNP's electoral support, cautioning against an early election. The Tories have promised a firm date for devolution referenda. But they, unlike Labour, will campaign strongly for a "no" vote; and will interpret negatively anything but a clear cut vote over the 40% (the referenda are consultative). If the SNP intend to bring down the Government, they may concentrate their pressure on an unequivocal demand for a guaranteed share of Scottish oil revenue. If, as seems more likely at present, they decide to let the Government through, they may seek, in particular, a stronger role for the Scottish and Welsh Development Agencies and, perhaps, in the wings, an understanding from the Government that a referendum vote, even if less than or around the 40%, will be interpreted positively so far as the establishment of assemblies is concerned. Either way, the Nationalists will doubtless be seeking the maximum publicity from their



pivotal position so that their intentions may remain unclear until the last moment. Likewise, they will certainly want to avoid the damage of a split vote among themselves.

If the Queen's Speech is carried, the next electoral threshold will be generally seen as late February/early March when the new electoral register is in force.

The uncertain voting situation at Westminster will, however, cause the Government continuing problems. In addition to meeting the continuing threat of challenges at Westminster the Government can also expect intermittent divisions in its own ranks on a number of fronts including economic policy (an EMS debate is anticipated before the December European Council). Despite these difficulties, most comment at the moment, including Conservative opinion, sees the Government capable of continuing well into 1979.

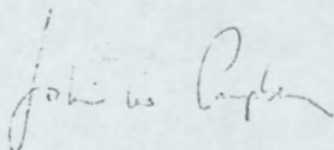
#### By-elections

The two seats which are the subject of by-elections on 26th October are both Labour vacancies. The Labour majority in October 1974 at Pontefract and Castleford was 23,000. On the basis of recent by-election results there should be no risk of Labour losing the seat. In the past eight by-elections going back to August 1977, the highest swing against Labour has been 9.4%. The Tories would need a 27.1% swing at Pontefract. The highest Conservative swings since 1974 have been those of 20.9% at Ashfield eighteen months ago and 22.5% at Walsall North six months previously.

At Berwick and East Lothian the Labour majority over the Conservatives in October 1974 was less than 3,000. The seat has changed hands between Labour and the Conservatives four times since the war, and a Labour loss is certainly on the cards. Polls over the late summer have all show Labour doing strongly in Scotland, with an improvement for the Tories also but a poor showing for the SNP. John Mackintosh.



whose death caused the Berwick vacancy, was a nationally known figure but the personal vote in his case would be hard to assess since although his energetic and imaginative personality attracted votes he also aroused some antagonism. If Labour were to hold on to Berwick it would be an excellent result for them and a bad blow for the Conservatives, who need no more than a 3% swing to take it.



John H.F. Campbell  
Minister Plenipotentiary



The State of the Parties at Westminster

Labour	-	306
Conservatives	-	282
Liberals	-	13
Scot. Nationalists	-	11
Unionists	-	10
Plaid Cymru	-	3
Scot. Labour	-	2
Soc. Dem. Labour	-	1
Independent	-	1
Vacant (both previously Labour)-	-	2
Speaker and three officers	-	4
Total	-	635