Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Economic Letter

Three Quarter-Centuries of Central Banking in Ireland

by Patrick Honohan [1]

Vol 2018, No.3

Abstract

The 75-year history of the Central Bank of Ireland falls neatly into three contrasting quarter-centuries. For the first quarter-century (1943-68) Irish banking continued to operate as a kind of satellite of the British system, with the Central Bank maintaining the non-interventionist approach that had characterised the currency board regime in place from 1927. The second quarter century (1968-93) was a period of monetary instability with double-digit inflation and repeated devaluations. Hyper-globalisation has defined the most recent 25 years (1993-2018) of the Central Bank's operations, with the Irish economy experiencing a damaging episode of over financialisation followed by a collapse, from which the Bank sought to navigate a recovery that would minimise economic damage. Evaluating national economic performance in each of the three periods on price stability and average job growth, the most recent quarter century outperforms the other two; but it has been more volatile.

1 Introduction

I have been asked to say a few words looking back at the history of the Central Bank of Ireland over the past three quarters of a century. Actually the story falls neatly into three very distinct and contrasting segments, each a quarter century long. These I will call the era of post-colonial quiescence; the era of monetary instability; and the era of hyper-globalisation. But first, how did it all begin?

[1] Governor of the Central Bank of Ireland from September 2009 to November 2015. Corresponding author: patrick.honohan@gmail.com. This Economic Letter contains the text of remarks at an event in Dublin marking the 75th Anniversary of the establishment of the Central Bank of Ireland, February 2018. The views expressed in this Letter are those of the author and do not necessarily reflect the views of the Central Bank of Ireland (CBI) or the European System of Central Banks (ESCB).

2 Origins

The Irish Free State allowed two decades of independence to pass before creating a central bank, relying instead on a currency board arrangement. It operated out of a property built on leased land in what was effectively the side-yard of the Bank of Ireland in Dame Street.

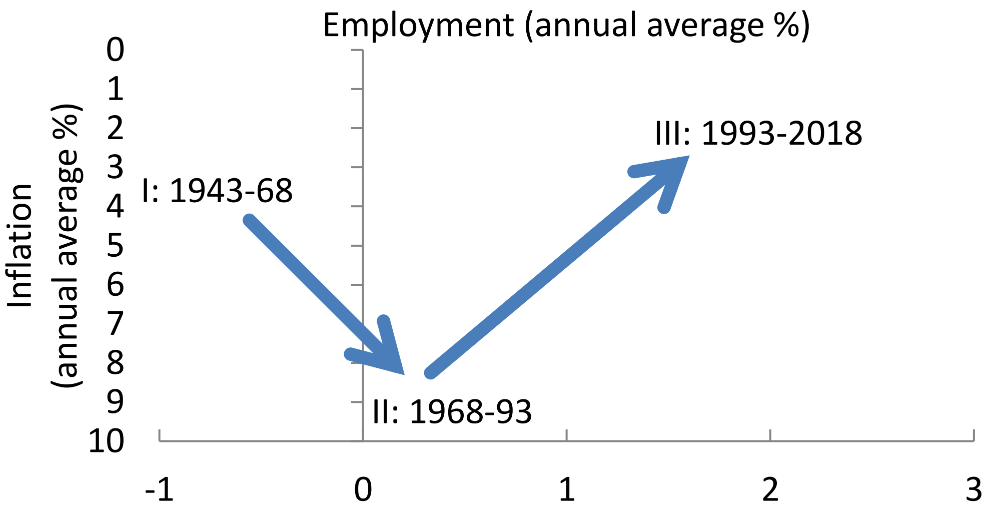
In those days, the commercial banks had no enthusiasm for the establishment of a central bank. When the somewhat radical Fianna Fáil Government set up a *Commission of Inquiry into Banking, Currency and Credit* to see what needed shaking up in Irish banking, the banks' main representative stated that "nothing whatever is wrong with the system…of currency, banking and credit".[3]

An unlikely convergence of interest between two very different elements in the late 1930s was needed to break the banks' opposition. One element was represented by the strongly nationalist, but economically conservative, public servant Joseph Brennan who, as Chair, ensured that, when it reported in 1938, the Banking Commission *did* recommend the creation of a central bank — though with little evident enthusiasm.

The other element was sitting in Threadneedle Street, London. This was Bank of England Governor Montagu Norman, who was scheming to create an international network of central banks with which he could stage-manage the monetary and financial affairs of the world without having to work with or through national governments.

As war approached in 1939, the Dublin banks made precautionary inquiries to see if the Bank of England would help out with emergency liquidity if needed. Norman's diary records his firm response "Éire is a Dominion and we in London cannot provide Emergency needs".[4]

Figure 1: Three Contrasting Eras



[3] Quoted from the Addendum to the Banking Commission's 1938 Report by Charles Campbell, Lord Glenavy, a Director of the Bank of Ireland.

[4] Thanks to Eunan O'Halpin for drawing my attention to this quotation. Cormac Ó Gráda refers to the incident also in his 2011 Whitaker lecture.

Without a lender of last resort, the functioning of the Irish banking system in the wartime economy could have been disrupted. The banks' opposition to the creation of a central bank, creator of liquidity, crumbled.

In the event, there was no actual need for emergency liquidity in World War II. But central banking is a long game and the ability to ensure bank liquidity in a crisis ultimately proved to be a powerful and necessary tool.

Now: what about the three contrasting eras: post-colonial quiescence, monetary instability and hyper-globalisation?

3 1943-68 Post-colonial quiescence

The funny thing about the early years of the Central Bank is that it used almost none of the powers that it had been given, operating largely as if it was still a post-colonial currency board, managed by the same team. (When Brennan retired in 1953, he had led the Bank and its precursor since 1927; second Governor J.J. McElligott was on the Central Bank board from its inception until the mid-1970s, having stayed on for fourteen years after his term as Governor expired).

Irish banking continued to be a kind of satellite to the British system. This was the timeless and unchanging world in which I grew up, when the coins in my pocket were as likely to show a British monarch as an Irish farmyard animal. Over 90 per cent of the Central Bank's foreign exchange reserves were held in sterling; the commercial banks continued to use the London money market for liquidity; the commercial Bank of Ireland, established by royal charter in 1783, continued to be the Irish Government's main banker.

Even the Marshall Aid dollars, when received by Ireland, were quickly converted into sterling and deposited at the Bank of England. (Unfortunately, this happened just weeks before the 1949 sterling devaluation).

For many, the main policy intervention of the central bank in those early years seemed to be its outspoken critique of the "constantly increasing scale of [Government] expenditure." Indeed, policy was constrained by the determination not to be forced off the currency peg—an attitude conveyed by Governor TK Whitaker's later admonition to Government that "it would not be a source of national pride to have to admit that the Irish pound could not look even a depreciating pound sterling in the face". (CB Files)

Unsurprisingly, the Central Bank was not enthusiastic when the Government tried to stray from this narrow path—as for example when, in 1955, the Minister for Finance strong-armed the banks into holding their interest rates down, despite an increase in the (London) Bank Rate. But the Central Bank's pushback was ineffective. Maurice Moynihan, a later Governor, wrote:

> "[The banks] were left with the feeling that the course which they had been persuaded to follow was not entirely the appropriate one. The Central Bank on the whole sympathised with them, and representations, both oral and written, were made to the Minister by the Governor in February and March 1955 and were renewed from time to time." (Moynihan 1975)

There followed a cascade of Government policy mistakes resulting in a serious recession 1956-7.

It was not that the Central Bank was indifferent to economic development. In the archives I found a 1957 letter from McElligott to University College Dublin (UCD) History Professor Desmond Williams

– in which he complained that UCD had "one professor of economics and seven professors of Irish of one kind or another…and yet we wonder why we are not making more progress in the development of our industry and our agriculture" (CB Files).

How did the economy do overall in the Bank's first quarter century? With inflation averaging under 4 per cent per annum we could give it a *B+* on price stability, but at best a *D* on aggregate employment, which *fell* by 0.7 per cent per annum.[5]

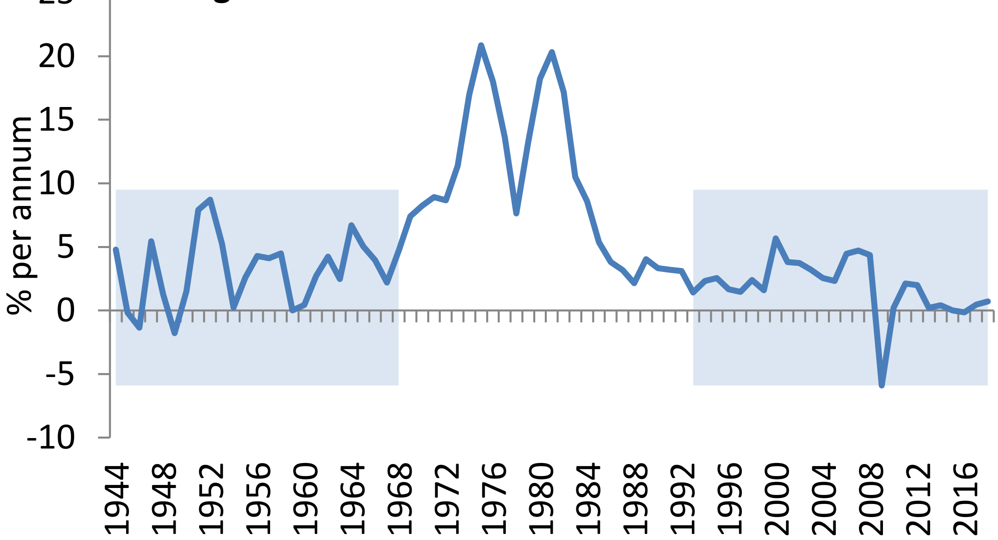
Curiously, the Central Bank's Annual Report for 1968 makes no mention of the Silver Jubilee! By then, things were beginning to change at the Central Bank. It had begun to enforce an aggregate credit ceiling policy, had become the main holder of foreign exchange reserves and was looking forward to legislation which would enable it to "control…the establishment of banking institutions and keep their operations under review."

It had also just sought planning permission for a new HQ office building in Dame Street – the controversial Sam Stephenson tower which would not be completed until 1980. (CB Annual Report 1967-8).

4 1968-93 Monetary instability

Monetary instability characterised the second quarter century. First, there was the trauma of the 1970s with a surge of double digit inflation imported from Britain and from the oil shocks (Figure 2).

Figure 2: Ireland: CPI inflation 1943-2018



[5] Mean inflation of 3.76 per cent per annum with a standard deviation of 3.48 per cent; mean policy interest rate of 4.0 per cent. Aggregate employment fell from 1.244 million (in 1946) to 1.077 million (in 1968): an average annual decline of 0.7 per cent per annum.

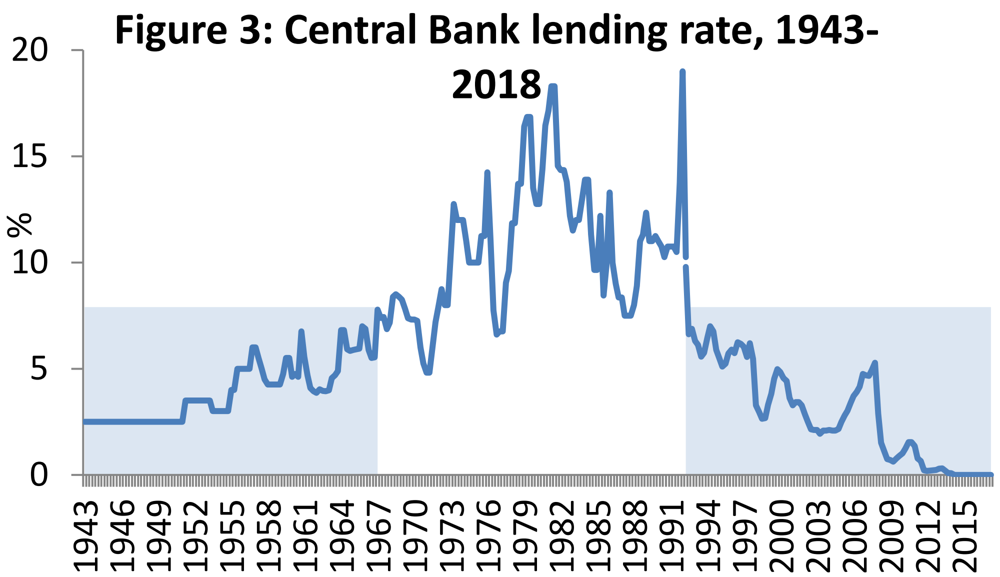


Figure 3: Central Bank lending rate, 1943-2018

Then came the European Monetary System, billed as “a zone of monetary stability” but in practice quite the opposite. Repeated realignments were needed to protect the economy at a time of soaring fiscal deficits – though here the initiative was generally taken by Government not the Central Bank. (At the first realignment, Governor Charlie Murray asked: “How can I do nothing”).[6]

Nominal interest rates in Ireland started to carry a risk spread well in excess of what would have been needed to compensate for actual exchange rate changes (Figure 3).

And to cap it all, the Central Bank’s Golden Jubilee celebrations exactly 25 years ago were somewhat overshadowed by Government having to succumb to market pressure and devalue the Irish pound by 10 per cent with effect on the very day of what wags inevitably dubbed the “devaluation disco”.[7]

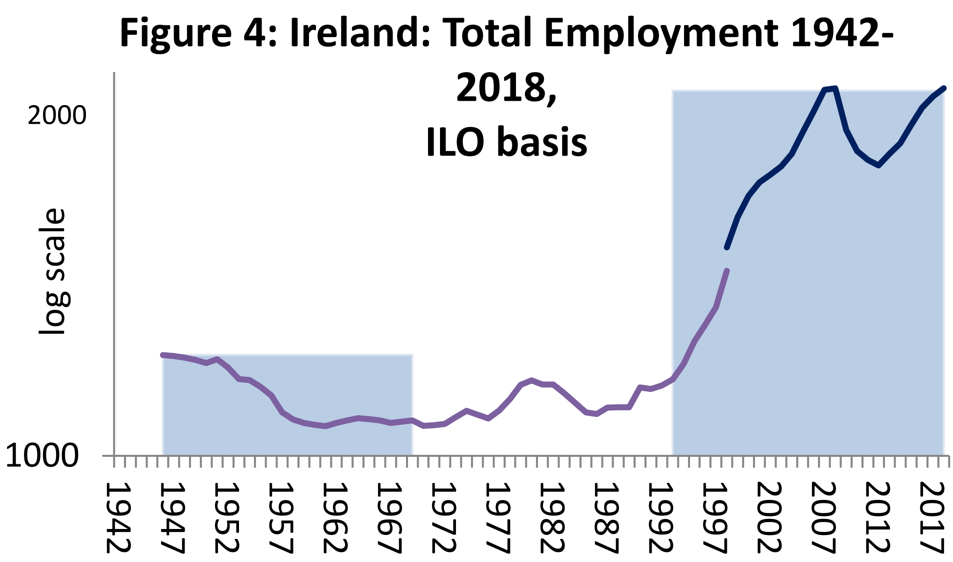
The second quarter century macro score-card: both annual inflation and nominal interest rates averaging about 10 per cent – no better than a grade of *C*; employment growth was better at an average of 0.4 per cent per annum: probably a *B*.[8]

Despite all the monetary turbulence, though, that period ended with the currency close to the old sterling parity. (Today it is even higher).

[6] Personal recollection.

[7] Governor Maurice Doyle had arranged for a celebratory concert in the National Concert Hall with The Irish Chamber Orchestra, Philip Martin and Micheál O’Suilleabháin.

[8] Mean inflation of 9.41 per cent per annum, with a standard deviation of 6.17 per cent per annum; mean policy interest rate at 10.7 per cent. Employment grew to 1.18 million by 1993.



5 1993-2018 Coping with hyper-globalisation

Taking the most recent quarter century as a whole, and despite the big setback of a decade ago, Ireland's *average* inflation (less than 2% per annum) and employment growth performance (almost 2½ % per annum) have been much better (Figure 4).[9]

This has been the era of globalisation. Despite the serious reverse 2008-11 this has been a period of on average strong improvement in the main macroeconomic aggregates in Ireland (Figure 5).

(In addition, available data suggest that globalisation has been accompanied by less of a deterioration in Ireland than in other advanced countries in such measures of poverty and inequality as the proportion of the population below 60% of median income, or the "experiencing basic deprivation" measure).[10]

Navigating hyper-globalisation has been far from trouble-free for Ireland. Greatly increased dynamism, but also a greatly increased potential amplitude of reversal if the dynamism is not properly controlled.

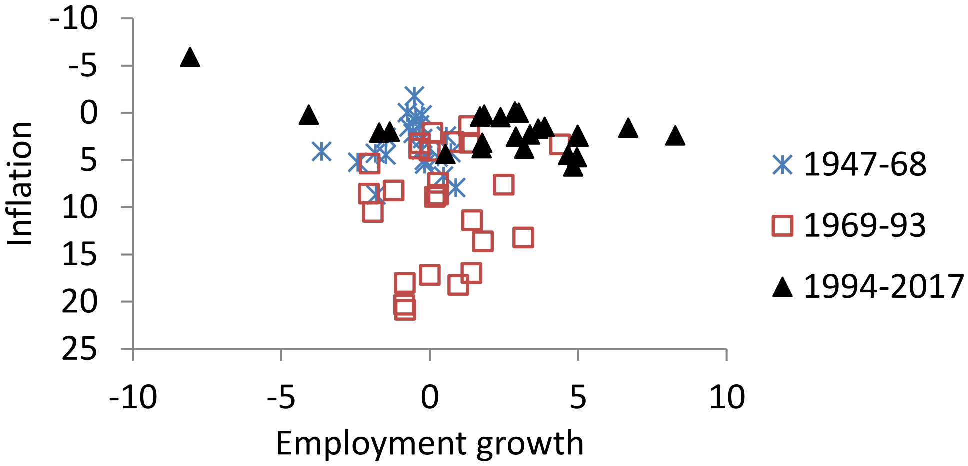
With the banks both inspired by, and especially financed by, the lavish expansion of global finance, globalisation has been accompanied by an over-financialisation which caused much damage.

When the collapse came, it was on a scale that required us to have recourse to the global public financial sector to make the funds available to protect public services as fiscal adjustment took place.

[9] Inflation has averaged just 1.90 per cent per annum with a standard deviation dev 2.32; mean nominal policy interest rate 2.85. Admittedly this figure doesn't capture banks' marginal cost of funds during the crisis; but the figure would be still around 3 even if we added the local short-term bank credit risk premium during 2009-13. And employment expanded by an average of 2.4 per cent per annum to reach 2.05 billion by 2017 (albeit still a bit below the bubble peak of 2007-8).

[10] Though very top incomes did increase their share.

Figure 5: Three Contrasting Quarter Centuries, Annual Data, % Change



In the process, the Central Bank's balance sheet ballooned to €205 billion (in 2010) – much larger than GDP and in relative terms one of the largest central bank balance sheets in the World!

The Central Bank sought to navigate the debate about bailing-in and bailing-out to ensure that overall debt financing was on much less onerous terms than seemed possible at first.

And now the Central Bank is in another new HQ building. Why another move? The answer is the increased staff, thanks mainly to the mushrooming role of financial regulation. 25 years ago there were just 59 staff in financial regulation – less than 10 per cent of the total headcount. When I stopped counting, the staffing of financial regulation had increased tenfold and now I believe accounts for more than half the total. It is partly a global trend; partly a reflection of the fact that almost all of the regulation of financial firms in Ireland is entrusted to the Central Bank – banks, credit unions, insurance firms, investment funds, brokers, and so on.

6 The future?

What *ex post* label will be attached to Irish central banking after the next quarter century has been accomplished? Possibly "post-bank". The power of the big deposit banks may be eroded by:

(a) resolution policies which will ensure that they are no longer too big to fail;

(b) technological innovations which may allow technology and communications firms, or the Central Bank itself, to capture payments, and some credit, functions from private banks (which have struggled to manage their own technologies); and

(c) if they fail to establish a culture of service to their retail customers.

In such a world the core function of the Central Bank will remain the same, preventing the abuse, public or private, of monetary systems that can destabilise economies and damage the economic welfare of their inhabitants.

In order to deliver effectively on this, the Central Bank will continue on the path it is pursuing today:

aiming to attract a highly-skilled, technologically aware and astute staff; maintaining active collaborative relations with its international peers; and ensuring that it is prepared to be more pro-active and intrusive than in its early decades.

In that way it will help fulfil the constitutional mandate that "in what pertains to the control of credit, the constant and predominant aim shall be the welfare of the people as a whole."

References

Commission of Inquiry into Banking, Currency and Credit. 1938. *Reports* (Dublin: Stationery Office).

Moynihan, Maurice. 1975. *Currency and Central Banking in Ireland*. (Dublin: Gill and Macmillan).