

Memoir:
Central Bank and Government
1969-1976

T.K. Whitaker



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Foreword

It is a privilege to introduce this publication of T.K. Whitaker's *Memoir: Central Bank and Government 1969-1976*.

T.K. Whitaker stands among the most consequential figures in modern Irish public life. His contribution to the economic development of the State, to the quality of public administration, and to the shaping of policy through disciplined analysis and principled advice is of lasting significance. That contribution extended to his period as Governor of the Central Bank of Ireland, during which he brought to the institution the same clarity of thought, integrity of purpose and deep sense of public duty that had already distinguished his earlier career.

2026 marks 110 years since T.K. Whitaker's birth and 50 years since the end of his term as Governor. Those milestones offer a fitting occasion to reflect not only on the scale of his legacy, but also on the continuing relevance of his work to the conduct of public policy and central banking in Ireland.

This *Memoir* is valuable on several levels. It is a record of a formative period in Ireland's economic history, marked by profound domestic and international change such as inflation, fiscal pressures, exchange-rate questions, the challenge of external shocks, and continuing debate about the proper relationship between government policy and central banking. But the *Memoir* is also an account of institutional development, showing the Central Bank in the process of defining its role, responsibilities and independence within the framework of a modern democratic state. And it is, of course, a document of enduring intellectual interest, because it reveals Whitaker's method of careful, rigorous analysis, his respect for evidence and his belief that policy should be grounded in realism, restraint and the long-term public good.

Readers of this *Memoir* will recognise Whitaker's distinctive voice. It is measured but candid, analytical but never detached from consequence, and always attentive to the practical demands of government and administration. He understood that public institutions must work together, but he also understood that they serve the State best when they speak honestly, especially at moments of difficulty. In that respect, this is more than a historical document. It is also a reminder of the value of institutional integrity, intellectual independence and public service conducted with courage and humility.

I am delighted that we are making this *Memoir* more widely available. In doing so, we are helping to preserve an important part of the Central Bank's own history and of the wider story of economic policymaking in Ireland. Contemporary readers can engage directly with Whitaker's reflections on the responsibilities of central banking, the pressures of public finance, and the complexities of policy formation in a small open economy.

While the text is very much of its time, many of the questions it raises remain familiar: how institutions should balance short-term pressures against long-term stability, how economic policy can respond to shocks without compounding them, and how public trust is sustained through competence, candour and sound judgement. Whitaker approached these questions with exceptional discipline and seriousness. That is one reason why his work continues to merit attention.

This publication is offered in that spirit, as a contribution to the historical record, to informed public discussion, and to a fuller understanding of one of the most important public servants in the history of the State.

A handwritten signature in black ink, appearing to read 'Gabriel Makhlouf', with a horizontal line underneath the name.

Gabriel Makhlouf
Governor
14 May 2026

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CENTRAL BANK AND GOVERNMENT, 1969-1976

T.K. WHITAKER

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March, 1979

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Central Bank and Government, 1969-1976

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CENTRAL BANK AND GOVERNMENT, 1969-1976I. INTRODUCTION

The older Central Banks owed their origin to a monarch's financial need: their first function was to add to the money supply. But the power of the purse is quickly recognised and is enjoyed with all the greater fervour when clothed with responsibility. So, as experience grew and understanding deepened, Central Banks came to see themselves, and to be seen, as controllers of the money supply for the public good. They still created money for Governments in times of war and difficulty - preferably within a framework of controls over incomes and supplies. But, especially since the First World War, the public have looked to their Central Banks as protectors of the currency, as a brake on the present-day tendency of Governments, no less than the Kings of old, to debase the value of money by over-spending in relation to resources.

On this view of the Central Bank as part of a system of essential checks and balances, a great deal of independence had, by the time of the Second World War, been acquired by the older institutions, or been expressly conceded by statute to the more newly established. In the wake of the War, and under the stress of obligations assumed in relation to economic growth and full employment, Governments have been clawing back power from Central Banks. Illusory equations between scarce resources and unlimited aspirations can be written only if the supply of money is elastic and its value continuously declines. Friedman, insisting on a controlled supply of sound money, is the great theoretical upholder of the independence of Central Banks but their position for some time has been a tense and uneasy one everywhere, as they strive to carry out a role which is no longer, in the democratic context, unambiguous, or even within their capacity in a technical sense. Are they, in Sir Stafford Cripp's phrase, mere creatures of the Government, bound to

supply the money required by Government policies; or do they still have some obligation, exercisable within a democratic constitutional framework, to restrain excesses and protect the value of money? It is in the belief that these questions and the evolution of the relationship between Central Banks and Governments are of universal and abiding interest that it seems worthwhile to review the Irish experience over the period 1969-1976 when I was Governor of the Central Bank of Ireland.

What I have set out to do in this Memoir is to give some account of the nature of the advice given by the Central Bank to the Government, supplementing in this respect the published Bulletins, Reports and Governor's speeches. I believe this advice to have been generally sound but on this I am, of course, in no position to offer a neutral judgement! The Memoir also deals with controversial issues, affecting the degree of autonomy of the Central Bank, which came to the fore during my time as Governor, e.g. responsibility for the control of credit, regulation of interest rates, management of the external reserves. The Memoir is necessarily selective in the sense that it is concerned primarily with argument and dispute over policy issues. It omits reference to matters of considerable importance to the Bank itself, such as the extension of its functions under the 1971 Act, the establishment of a printing house and mint, and the problems connected with the building of its new headquarters. I have tried to let the contemporary records speak for themselves, using only the minimum of narrative and comment to thread them together. This procedure will, I hope, prove of some benefit to a future historian.

If at times the Memoir seems narcissistic, I must, with apologies, excuse this as being unavoidable where so much of the drafting and writing was personal, although on major matters the subject of discussion and endorsement by the Board of the Bank and, at all times, within my understanding, as Governor, of the Board's thinking and outlook. I benefitted greatly from consultation with the senior management on all important issues.

I have deliberately not reproduced memoranda of the Department of Finance which I received in confidence before their submission to the Government. These will be available to the historian in the files of the Department and the Central Bank. Sufficient indication is, however, given of Finance proposals to make the Bank's reactions intelligible.

Before I was appointed Governor (1 March 1969) I had spent thirty-one years in the Department of Finance, the last thirteen of these as Secretary (Civil Service head) of that Department. My first task in the Department had been the preparation of submissions to the Government on the recommendations of the Banking Commission (1934-38), one of the most important of which favoured the conversion of the Currency Commission into a Central Bank. I had therefore seen at close quarters, and with an insider's view of relationships, the beginnings (1942) of the Central Bank and the gradual coming into play of its powers and functions. I need not describe these developments here as they are reviewed in Dr. Moynihan's history.* I have appended a synopsis which shows that the Department of Finance played generally a co-operative, and, at times, an initiating role. (See Appendix I).

I need only recall, because of their particular relevance to my story, the following facts of the situation in the Spring of 1969:

- 1) Because of the power to treat a "balance in the General Fund" as an asset of the Legal Tender Note Fund, it was possible for the Central Bank to acquire (for the General Fund but with sterling or dollars of the Legal Tender Note Fund) large amounts of Irish Government securities. Its potential to add to the money supply by providing credit for the Government was, therefore, substantial.
- 2) In fact, the Central Bank had been sparing in providing "lender of last resort" facilities, whether for banks or Government. Only £3.6 million of rediscounted Exchequer Bills were in the hands of

* Currency and Central Banking in Ireland, 1922-60.

the Central Bank on 3 March 1969 and the maximum held at any one time previously was £15.2 million in 1966. Apart from Bills, the only Central Bank finance for Government outstanding was £20.5 million of Funding Loan (repaid later in 1969).

- 3) The Central Bank held official external reserves to the amount of £214 million (equivalent to 4½ months' purchase of imports at the then current level), while the Associated Banks held "net external assets" of £69 million. In the Autumn of 1969 it was arranged that all these reserves would be centralised under the control of the Central Bank and this process was completed in 1970.
- 4) The direct foreign borrowing of the State consisted mainly of the Marshall Aid Loan and did not exceed £55 million in all. The total public debt was £900 million.
- 5) The Central Bank had only begun the process of taking over (from the Bank of Ireland) the functions of banker and fiscal agent to the Government. It had not yet been assigned its licensing functions (Central Bank Act, 1971).

Another significant fact was that budgets were prepared and settled without any reference to the Central Bank, whose Governor was informed in confidence only on the morning of the budget of its major provisions.

Anticipating (with pleasure, as it accorded with my own wishes) my forthcoming move to the Central Bank, I wrote as follows to the Minister for Finance (Mr. C. J. Haughey) on 12 February 1969:

"Minister,

As the time of departure approaches I have been thinking of what my role as Governor of the Central Bank should be. That it should not be one of glum isolation in an ivory tower, relieved only by the hurling of belated

thunderbolts against erring Governments, I feel quite strongly; and I think that both you and the Taoiseach would favour my adopting a less frustrating and wasteful role, one involving a more active and useful exercise of the knowledge and experience I have acquired in the Civil Service.

This does mean, however, that there will have to be a far more active interchange of information and ideas between the Department of Finance (and other Government sources) and the Central Bank than has hitherto been the practice. I would welcome this and, indeed, I think it essential if the very difficult economic problems facing the country are to be dealt with. It has become only too evident that fiscal policy, monetary policy and incomes "policy" (always a misnomer, that) are undependable; they will certainly remain ineffective unless properly integrated.

The Central Bank has its special functions and responsibilities but these are related to objectives (stability of the exchange value of the currency, a reasonable balance of payments position, moderation of domestic cost and price increases) normally shared by Governments and obviously it is only if there is full co-operation, based on confidential exchange of information and argument, that these common objectives have any chance of being attained.

As an illustration of lack of communication and policy integration in the past, I might instance the practice of telling the Governor of the Central Bank only on the morning of Budget Day what are the main features of the budget. At that stage, it is too late for him to say anything; yet the budget proposals - current and capital - create an economic environment in which the Central Bank has to try to operate a credit policy consistent with the major objectives referred to above. This just does not make sense. The Minister for Finance and the Government do not have to take the advice of Secretaries or other senior Civil Servants, but they receive it in time to consider it. Neither do they have to do what a Governor of the Central Bank may advise. But economic policy, particularly demand management, will not be well conceived or oriented if the views of the body immediately responsible for money and credit are not sought or heard at the formative stage.

Central Banks, though accorded a good deal of statutory independence, are in the last resort an instrument of Government policy. If their separate status is justified - that is, if they are to be something other than a Department of State - they must have considerable independence of day-to-day action in relation to monetary and credit policy.

This can work well only (1) if the Central Bank knows what is happening, and what is contemplated, regarding the public finances and economic and fiscal policy generally and (2) if certain objectives and limits are accepted in common (e.g. that external reserves in a particular year should not sag by more than a limited amount). Not only should the Governor have confidential access to relevant information but he should have frequent occasions for discussion with the Minister, the Secretary and other senior officers of the Department of Finance, and similar access to senior personnel in other economic Departments and agencies. I would like to feel that a new, active, confidential relationship of this kind is favoured.

I would also like, as you know, to maintain my interest in North/South affairs, at least to the extent of arranging for some studies to be made of the economic and financial problems connected with any formula or arrangement for the unification of Ireland. An Assistant Principal on Mr. Maher's side has been working intermittently on this and I would be glad if, in the future staffing of the Department, provision were made for a continuation of such studies under my general direction.

Needless to say also, I shall be happy to undertake any economic or administrative service for you or the Government which can be fitted in with my job as Governor. I hope to have an opportunity of polishing up my economics and later, perhaps, of making a fresh study of some of our major economic problems. "

I added in manuscript "Mr. C. H. Murray has expressed his full agreement with the views in this minute". The Minister wrote "So do I - C.J.H." In fact he added a separate note in his own hand in generous, not to say extravagant, terms as follows:

" Secretary,

All this goes to prove how fortunate it is that we are about to have a wise, skilled, progressive Governor take over in the Central Bank. "

The auspices seemed good.

II. ADVICE AND COMMENT, 1969/70

The "exigencies of the public service" ordained that I was to spend my last day in the Civil Service, 28 February 1969, in trade negotiations in London. There was a brighter side to this day than the prolonged wrangle about the import quota for Irish cheese on which the Minister for Agriculture (Mr. Neil Blaney) was engaged. We carried away the agreement of the British Government to waive the Damage to Property Annuity which Ireland had been paying since 1926. This relief was worth £4 million and I was particularly gratified because I had unearthed this possibility of a cash benefit to top up Britain's meagre trade concessions and pressed it successfully on Treasury officials and the Financial Secretary, Mr. Harold Lever, M.P.

The financial year still ran from 1 April to 31 March and the first important event confronting me in the Central Bank was the Budget for 1969/70. In his Budget Speech, the Minister for Finance was to say that "1968 was the best year in our economic history". Gross National Product rose by an exceptional 7%, restoring the average for the 1964-1968 period to the 4% norm, and industrial production by 11%, with the balance of payments deficit only £20 million. But signs of inflationary pressure were already visible in the second half of 1968 - including an upsurge in prices, incomes, public expenditure, consumption and imports - and some measures had been taken in November 1968 to check excess demand.

Non-agricultural incomes rose by 10½% in 1968 and prices by nearly 5%, as compared with 3% in each of the five previous years. The devaluation of sterling in November 1967 was beginning to make its full impact and, supported by other inflationary influences, domestic and external, was about to carry the consumer price index on the steep upward course which took it to 7.4% in 1969, to an annual 8½% on average through 1970 to 1972 and then to 11.4% in 1973, 17% in 1974 and the 21% of both 1975 and 1976. It took thirty years to halve the value of the 1922 £ but the halving of purchasing power process at the 1975/76 rate would take less than three years! Fortunately the tide turned and the inflation rate was reduced to 14% for 1977 and 8% for 1978.

At the beginning of 1969 an ominously steep increase in pay (over 20%) was accorded to maintenance craftsmen and there was widespread apprehension about the consequences for the economy if this were to set a headline for general pay revisions. Public current expenditure had also been gathering momentum, rising at an annual average rate of 12 to 13% over the years 1963 to 1968, in contrast with the average real growth of 4% a year in national output, with the result that the proportion of gross national product taken in taxation was climbing and was already almost 29%.

This was the scene in March 1969 and my first message to the Minister for Finance by way of manuscript note on 28 March referred to the large prospective deficit on current account which had not yet been eliminated in the preparations for the 1969/70 Budget. I had been brought up to date in confidence about the position and, in addition to some specific suggestions on the Agriculture front, urged the Minister:

"This year above all the Government itself must earnestly try to avoid raising the price level by indirect taxation or adding to wage and salary pressures by direct taxation. To bring (current) expenditure down to parity with revenue should be the prime, if possible the only, aim".

On 16 April, when the budgetary dispositions were (as I thought) close to finality, I wrote more extensively and specifically to the Minister:

"I am afraid (from experience) that to start with a balance on current account provides no guarantee of ending with one, particularly when the "cuts" in Estimates have been rather severe. We have found in the past that some Departments - especially Agriculture - accept reductions in a Machiavellian spirit, knowing that the forces of nature and politics will prevent the cuts being realised and, indeed, will require millions of extra money to be found for "open-ended" services. The Sword of Damocles of pay increases for the public sector overhangs the 1969/70 scene and there is also the consideration that some £2 million of Import Deposit Interest Compensation* should strictly be included with current, rather than capital, outlay.

I would urge, therefore, that a prospective surplus should underlie what may be presented as an initial balance or small deficit, so that there will be something sizeable in hand to meet the contingencies ahead. A deduction for "errors" should not be a feature of this year's arithmetic.

* This refers to the scheme devised and introduced, with the active co-operation of the Associated Banks, to overcome the import deposit restrictions imposed by the U.K. - T.K.W.

It would be desirable in principle, as a contribution towards quietening the incomes front, not to have any Government-sponsored raising of prices through taxation this year, but, unless this rested on a genuine basis, I would prefer to see social welfare or other budgetary concessions kept to a moderate total and paid for by notching up a few of the taxes on consumption. If the total addition to expenditure were large (which Heaven forefend) I would be in favour of resort to a direct taxation increase.

My reasons in brief for this attitude are:

- (a) Despite your publicity campaign and the ITGWU President's speech, it would be taking a big risk to assume that there will not be a splurge of substantial income increases during 1969 as an aftermath of the maintenance men's settlement and other pressures. It will in any case be a hard slog to bring about a lowering of the annual increase in incomes from the present 10 - 11 per cent. to the desirable 0 - 5 per cent.
- (b) The forecasts both in the Department and the Central Bank foreshadow a balance of payments deficit of £55 million in 1969 to be repeated in 1970. This is more than we can safely manage and a bigger effort to control it is called for, particularly as the growth rate prospect of well over 4 per cent gives room for this.
- (c) This is the time - before the recent propagandist build-up crumbles - to try hard to arrest the development of an inflationary psychology. This requires firm holding down of the excessively strong upward trend in current public expenditure and abstention from any significant Government-sponsored raising of prices through taxation.
- (d) To rely too much on credit restriction as a corrective would be most unwise as it can be crude and inequitable even when it is effective and the apparent favouring of Government, at the expense of private, needs would cause much resentment and an adverse political reaction. No decision on the advice to be given to the commercial banks has yet been taken but the indications are

that gross new credit creation in excess of £60 million in 1969/70 could push the balance of payments deficit beyond the £50 - 55 million limit. Commercial bank liquidity is now so low that to provide enough credit to meet the Government's needs, not to mention those of the private sector (for which a £60 m. aggregate would leave little room), a considerable amount of the money will, in effect, have to come from the Central Bank, through rediscounting and otherwise, and at the expense of a running down of external reserves. This can be faced only if during 1970 the external account is well on the way to recovery.

It is, I think, very important this year to publicise, and make effective, a change in budgetary and economic strategy aimed at slowing down the rate of increase in prices and incomes, making Irish goods and services more competitive, and returning to a more manageable balance of payments position. Containing the public expenditure rise within the existing high taxation rates is a desirable element in such a strategy. So also is a radical correction of the general expectation of high income increases - not just for the year 1969 but for 1970 and thereafter."

I followed this up with a manuscript note as follows on 5 May 1979, two days before the Budget was presented to the Dail:

- "(1) What you have done to contain the Estimates is being undone by excessive budgetary additions, the full impact of which won't appear during the year.
- (2) As a result, the increase in price-raising taxes is too great at a time when moderation in new income increases is being sought.
- (3) In a year when the budget should be disinflationary the probable inadequacy of the provisions made for CIE, dairy produce export losses, pay etc. is disturbing and should have banished any thought of a deduction for "errors"."

I made the same points in a personal note to the Taoiseach on the same day. But the die was cast. The budget increased social welfare and pensions provisions paying for this by indirect tax increases; personal allowances for income tax were increased and and apparent balance produced with the help of the deduction for "errors" criticised in my note. The amounts involved, by later

standards at least, were moderate but they accentuated the immoderate rate of increase in public expenditure, prices and pay. This was the budget which granted exemption from income tax for earnings derived from work of cultural merit. It was also, in fact, a pre-election budget: the Dail was dissolved on 22 May and in the General Election which took place on 18 June the Fianna Fáil Government were confirmed in office. As it turned out, one must record failure for this first attempt, by way of income tax reliefs and social welfare improvements, to prevent the exorbitant maintenance men's pay increase from being extended to workers in general.

The Central Bank issued its credit policy statement on 2 June. It did so in terms of a ceiling (£75 to £80 million) on total additional lending by the Associated Banks in 1969/70, specific advice within the general guide-line to be given to the various Banks and all being expected to reserve credit "primarily for productive purposes, especially, exports, and not to make it available 'to finance immoderate consumer spending' ". The Bank aligned itself with Government policy, as expressed in the 1969 Budget, by declaring the aim of credit policy to be "to reduce the pressure of inflation and while sustaining a high level of economic activity, to guard against any major or continuing fall in external reserves". The special chapter later devoted to Credit Policy in the Annual Report revealed a state of dissatisfaction with the then effectiveness, coverage and mechanism of control and indicated new lines of approach, including a variable liquidity ratio and the need to take account of the borrowing and lending activities of the non-Associated Banks and of the effect of foreign borrowing on net inflows of capital. The special difficulty associated with the dominance of the overdraft in Irish Banking was also recognised - bank customers being in a position for a time to defeat credit restrictions by drawing on the unutilised proportion of their overdraft permissions. These were all problems to which thought continued to be given and for which more or less effective solutions were in time found.

On the principle of striking while the iron was hot, I wrote to the Minister for Finance as follows on 3 July 1969:

Personal and Confidential

Dear Minister

You will not, I am sure, think it strange that a message of congratulation from the Central Bank on your confirmation in office as Minister for Finance - which I convey with every good wish for your happiness and success - should be accompanied by some exhortation as well.

On this occasion, unlike others in the past, the new Government is not confronted at once with the need to take some drastic financial action. But the tolerance already allowed to inflationary forces is dangerously liberal and there is, therefore, need for determined resistance to any slippage.

On the credit side, both the overdraft system (under which credit creation is to a large and unpredictable extent at the discretion of bank customers) and the disparities in liquidity between the major groups, will create difficulties in securing adherence to the Central Bank guide-line but we shall do our best to deal with these.

On the income side, apprehensions are renewed by the offer to extend the maintenance men's settlement to building workers.

As regards public expenditure, I expressed to you before the Budget the belief that the budgetary additions to current expenditure were excessive and the fear that inadequate provision for various services would re-open the current account deficit and deprive the Budget of its intended disinflationary effect. I instanced CIE, dairy produce export losses and pay and there would seem to be ground for believing that these and other services may cost millions more than has been allowed for - apart from any possibility ("madness" I would prefer to call it) of a further raising of the price of milk.

The general trend in trade so far affords no reason for revising downwards the estimate of a deficit of £50 million or so in the balance of payments. It is most important, therefore, that budgetary policy be adhered to and that no current deficit be allowed to occur. This is so not only because of the broader interest of the economy but also because of the problems created for your own Department by the coincidence of heavy Exchequer requirements for the Public Capital Programme of this and coming years with an unprecedentedly high level of interest rates and the imminence of vast conversions of previous National Loans. A strong budgetary position on current account would give you some resilience in facing these problems.

In so far as it might be intended to cover a budgetary slippage on current account, I would deprecate most strongly the proposed resort to DM borrowing. Even if there is no current deficit, the operation is questionable. The country is not so short of foreign exchange reserves that it must rush to borrow £10m. in a currency that is virtually certain to be revalued in a matter of months. The problem is rather the technical one of ensuring adequate domestic finance for Government needs and should not be impossible to solve given a tight financial policy under which public capital expenditure would be held at the limits already fixed, current expenditure kept within the revenue available, and any ultimate drain on exchange reserves limited to a temporarily tolerable size. The only good thing that can be said for this DM borrowing is that it affords more time at a difficult phase to work out an appropriate technical solution. "

This was one of the few occasions on which I had a Ministerial reply: "Thank you very much for your helpful letter and your views and advice. I will look again at the DM borrowing proposal and talk to you before taking a final decision".

The first Annual Report of my term of office was transmitted to the Minister for Finance on 16 July 1969. The "General Review", which I personally drafted, dealt particularly with the quickening pace of inflation but it also laid the foundations, later to be elaborated and strengthened, of the critical framework within which the Bank's comments and advice were set in the years that followed.

It was made clear that the Central Bank fully accepted - indeed, was anxiously preoccupied with - the objectives, namely, maintenance of a high rate of economic growth and progress towards full employment, which had once again been set in the Third Programme, published in March 1969.

But the essential pre-requisite was competitiveness; otherwise, in a free trade perspective, the growth - even the maintenance - of both export and home sales, and therefore of employment, would be frustrated.

The Bank's statutory obligation concerning "integrity" of the currency was interpreted as relating to the preservation of the appointed parity with sterling. The influence, in an open economy, of the price increases imported through the exchange rate linkage was acknowledged, as was the limited power of any individual country, particularly the smaller ones, to control the rate of inflation. But this made it all the more necessary not to allow domestic inflationary influences to make matters worse. The principal three initiating causes of inflation on the domestic scene were "over-rapid increases in income, inordinate government expenditure and excessive credit creation".

In the case of public expenditure, two separate consequences of an excessive upward trend were clearly perceived - (i) the spill-over effect of too much national spending on the external deficit and (ii) the price and pay effects stemming from the unwillingness of the public to accept the redistribution of incomes intended by higher taxation to finance social and other improvements. "Growth in public expenditure which outpaces the buoyancy of revenue requires an increase in rates of taxation in order to finance it. Such an increase in expenditure will have an inflationary effect unless the public in general are prepared to accept the rise in taxation without seeking to compensate themselves by means of increases in incomes. Generally, in the past, the public have not shown themselves willing to transfer real purchasing power to the Government out of their existing incomes". Indeed, this continued to be the experience and later Ministerial appeals to trade unions to ignore the effect of tax increases on the consumer price index fell on deaf ears.

The Report pleaded for what I might call a "virtuous differential", as against the evil tendency to exceed the exchange - derived rate of inflation. It stressed - and this was a point frequently re-stressed in later years - the importance of holding down the rate of inflation so as to improve Ireland's competitive position . . ." Given the

clear need not merely to maintain the level of employment, but to raise it substantially, the necessity of acquiring a competitive advantage becomes correspondingly greater". Another beneficial aspect of this "virtuous differential" which came increasingly to be emphasised by the Bank was the greater effectiveness (at less cost in terms of public borrowing) of public capital outlay in creating employment when wage and salary restraint was exercised.

Where convenience could be served without risk of confusion, the Bank's language favoured absolutes rather than relatives. It is tiresome to have to write always a form of differential calculus focussing on the comparison of rates of change; the word "relative" was introduced where necessary and "excessive" cost movements were always to be understood in relation to trends in Britain particularly. It should be remembered, also, that the pound sterling had a fixed rate of exchange with the U.S. dollar and other major currencies prior to the "floating" régime which, for the pound, commenced in June 1972.

During the Autumn of 1969 the economic situation continued to deteriorate, with the adverse trade gap widening and prices rising and the maintenance men's settlement being extended to building workers. A barrage of letters of criticism and advice was directed to the Minister and the Secretary of the Department. I wrote to the Minister on 11 September, 22 September and 21 October and to the Secretary (in the context of the proposed Public Capital Programme for 1970/71) on 27 and 31 October. As the main arguments in these letters were put forward again at an interview with the Minister on 3 November 1969, from which I shall quote in a moment, I need not reproduce the letters in full here. But they did contain some spirited passages, far removed from dull officialese.

The letter of 11 September, made the point that "credit control is made difficult in the short-term by existing commitments of banks under the overdraft system of lending. In any case, credit control, however effective and severe, cannot undo harm already done to the competitiveness of Irish goods and services by relatively large cost and price increases due to excessive jumps in wages and salaries and steeply rising taxation. There is no doubt that excessive income (and expenditure) increases are facilitated by "soft" fiscal and monetary policies. Closing a budgetary gap by raising

taxation can itself be inflationary. If an increase in taxation should be necessary to prevent a deficit, it would be more appropriate that it should be direct, rather than indirect, taxation. What is at issue is whether the present high rate of inflation should be allowed to continue until it makes our goods and services uncompetitive and forces severe contraction of production and employment, or whether it should be reduced below the rate of inflation in Britain - thus opening the way to a steady expansion of production, employment and real earnings.

The letter of 22 September to the Minister stated that it would take sustained action on the three fronts - incomes, public expenditure and credit - even to bring inflation slowly under control. It went on:

"I am glad to hear that you are meeting ICTU and I hope you will have some success in bringing home to them (and the rank and file) the damage that must result from the current phenomenal standards of pay increases. How far this will be effective in stemming the present flood is doubtful. Don't let this deter you. Far too many people - in Government Departments, ICTU and employer organisations - are throwing in the sponge and accepting that 20% all round is now inevitable whatever the consequences. This is dangerous psychology which a Minister for Finance should resolutely resist. It may be some comfort to you to know that Jimmy Dunne affirms that your television speech late March was decisive in averting the pursuit of claims by his and other unions for immediate parity with the maintenance men I am aware from NIEC discussions about incomes policy that everyone is ready to condemn inflation (a fate it shares with sin) but no one wants to take any awkward or unpopular action to correct it. We are like a group of "junkies" who are expected to "unhook" ourselves while drugs are freely available. As the doctor you must be stern to be kind, particularly as you are expected to sponsor a healthily growing economy for the next five years. I have often stressed the importance of being seen to be in control of the situation; if confidence goes, all our financial troubles, bad as they already are, will suddenly become worse, if not indeed unmanageable".

Coming now to the interview on 3 November, my record, dated 4 November, includes the following:

I said that all the estimates, departmental and external, pointed to a balance of payments deficit of £70 to £80 million in 1970. This was a bomb on which we could sit no longer. Action to control inflation was an urgent necessity.

** General Secretary of the Marine, Port and Dockworkers Union and Resident, ICTU.*

This action had to be directed to the basic causes. These were excessive income increases and the over-rapid rise in public expenditure.

Even if the maintenance men's settlement was modified in various ways as it spread through the economy the consequential income increase in 1970 could be expected to be at least 15 per cent. - three times as much as the probable rise in real national output. If this was allowed to happen there was no hope of checking the present high rate of price inflation. There had been talk for years about an "incomes policy". The trade unions were always prepared to take part in this talk provided (a) nothing was done about the current or prospective round of wage increases, (b) the policy applied to profits and all other forms of income and (c) there were no legislative or other sanctions to ensure its implementation. Employers, for their part, ran before the wind. While it was right that we should be humanitarian and try to avoid corrective action which caused unemployment, some discipline had to be introduced into economic management; otherwise there would be no peg in the system - everything would give eventually, not only wages, prices and the balance of payments but even the exchange rate. It was the Government's job to introduce this discipline and to back it up with an adequate education or propaganda campaign. It should not be too readily assumed that there was no place for legislative sanctions in incomes policy. The British had found that a complete statutory standstill on wages worked for a limited period. The trouble arose only when the period was over. Was it impossible to envisage making it unlawful for employers to pay more than a specified percentage increase in any year except a reconstituted Labour Court or new Prices and Incomes Board allowed more in particular cases? The trade unions would, of course, object in principle to any legislative sanction but it might well be that many people, including trade unionists, would be prepared to acquiesce in it tacitly as a means of preventing maverick activities. Without some such sanction to back them, institutional improvements, such as a new P.I.B. (Prices and Incomes Board) could be a costly illusion.

As regards public expenditure, I expressed disappointment that my fears about the 1969 current budget were being realised - that too much had been given away, too little provision made for uncovered expenditure, and a deficit situation was being allowed to arise which deprived the budget of any disinflationary effect. As regards capital expenditure, I merely referred briefly to my recent letters which stressed that the programme the Minister was recommending, involving a 10 per cent. increase as a minimum over this year, was quite excessive. The only sure way to control inflation through financial policy was to keep down expenditure. Extra taxation, even to produce a budget surplus, was no certain cure;

and this was true whether the taxation was direct or indirect, although the former kind was to be preferred at present if taxation were the only means of preventing a deficit on current account. The prospective borrowing requirement of the Government on capital account in 1970/71 was of frightening magnitude - some £80 million - and could not be met unless the balance of payments deficit were to be of the £80 million order and credit for the private sector were still to be severely limited.

This led me to emphasise the political as well as economic risks in Government "hogging" of all or most of the available credit. When the Minister referred to foreign borrowing being justifiable for aircraft and other assets earning foreign exchange I agreed, but I pointed out that the borrowing requirement for 1970 would involve more than this, if even a moderate amount of bank credit were to be left for the private sector. The important point was that the foreign borrowing would be incurred to finance a scale of expenditure resulting in an utterly excessive deficit in external payments. This situation could not continue. Sooner or later the voluntary capital inflow and the possibility of direct foreign borrowing would dry up and confidence, both at home and abroad, would be shaken by a sudden loss of perhaps £50 million of external reserves in a single year. As I had often said, it was vital that the Government be seen to be managing the economy well.

When the Minister asked what could be done in directions other than incomes and public expenditure, I referred to (a) the need to boost savings and (b) the possibility of controlling, directly or indirectly, imports of finished consumer goods. As regards savings, I stressed that an uphill job was being made more difficult by an annual rate of increase in prices of 6 to 8 per cent., and that the only hope lay in increasing contractual savings. I mentioned that Mr. D. S. A. Carroll had prepared a note on this in 1965 and that Mr. Duignan, Revenue Commissioner, had outlined a scheme (similar to one later introduced in Britain) under which savings linked to the payment of income tax would be free of tax if held for a minimum period of years but would suffer tax, on a diminishing scale, if withdrawn during that period. The Department's operations research study on small savings had, I understood, brought out that initial enthusiasm quickly waned; and this pointed to the desirability of a quasi-automatic system of deduction from pay. Any such scheme would have to be voluntary. The Central Bank would co-operate with the Department in trying to find ways of encouraging extra saving; the question was being actively studied at the moment.

Consumer imports might be tackled either by an import deposit scheme or, perhaps more effectively, by a surcharge. If we contemplate any such action it would be politic to observe the formalities vis-a-vis IMF, GATT, the U.K. etc.

Attention might also be paid to consumer credit, which was expanding fast; I referred particularly to "other instalment credit" which was not caught by existing hire-purchase legislation. Even the h.p. controls were purely nominal.

Before turning to other subjects, I again emphasised the primary importance, in the context of control of inflation, of bringing the trade unions to a sense of proportion about money income increases and taking stronger measures to curb the growth of public expenditure. "

In December, 1969, Mr. Murray sent me copies of memoranda he had submitted to the Minister for Finance on the economic situation and on the budgetary outlook. The rather bleak description of the economic situation and outlook was such as the Central Bank could endorse. During that month the Government issued a statement on incomes and prices, seeking to have a voluntary upper limit on wages and salaries brought into the process of industrial bargaining: some "teeth" were put into this appeal for restraint by the decision, announced in the Dail on 17 December, that increases in labour costs in excess of 30 shillings a week would be disallowed in considering applications for price increases. The information Mr. Murray had given me in confidence about the budgetary prospects for 1970 led me to write (on 12 December):

" I don't think it an exaggeration to say that, if it is not evident in the near future that the Government is taking the situation in hand, there will be a confidence failure, with most disagreeable consequences. Questions about the parity of the Irish pound are already in the air.

The basic requirements are moderation of growth of incomes and - what is more immediately within Government control - curbing the upward trend in public expenditure. The steepness of this trend in the recent past is almost beyond belief - a 19% rise in Government expenditure, capital and current, in 1968/69 over 1967/68 being followed, on present indications, by one of 17% this year, in absolute terms about £100m; these percentages are far higher than in Socialist Britain which, having brought the rise in public expenditure down to 8.3% for 1968/69 is planning to hold it for the next few years (W. P. C 4234) to 3% p.a. in terms of 1969/70 prices.

Unless the brake can be applied to incomes and public expenditure, all other measures (including import restraints) will be of little effect, being concerned with symptoms rather than causes.

As far as credit policy is concerned, I have told you on the telephone of our anxiety to be in a position to give advice for the financial year in advance, on the basis of reasonable assumptions regarding budgetary and general economic policy. "

I shall be returning shortly to the analysis and comment which, in the early months of 1970, were directed towards influencing the 1970 budget. Looking back on the record for 1969, one might consider that the attempt to influence policy was slightly frenetic - offending, perhaps, against Talleyrand's famous injunction "Surtout, Messieurs, pas trop de zèle" - but 1969 was a year in which the economy was seen to be slipping off the gradient of steady growth which had been attained after decades of inanition and despondency. The ESRI commentary shared this feeling of catastrophic change. Referring in December 1969, to "exceptionally large pay increases" as the main issue threatening the economy, the Commentary went on: "On its resolution depends whether or not the coming decade can improve on the performance of the one just ended" - a decade described as "a uniquely successful period of development in Ireland's economic history".

III. RESPONSIBILITY FOR CREDIT POLICY

August 1969, was, to apply Edna O'Brien's term, a wicked month. It was the month when violence erupted in Northern Ireland. I was on holidays with my wife and family in Carna, in the West Galway Gaeltacht. Early, on the morning of 15 August, Lá fhéile Muire Mór san Fhómhar, a Garda came to our rented cottage to ask me to get in touch at once with the Taoiseach. I phoned the Taoiseach from the Garda station (even with priority it took a good while!) and later drove to Galway to post him a written memorandum on some implications of the new troubles. The phone call done, I hurried to Mass but was a little late. The priest was fulminating against the evident reluctance of some of the congregation to adjust to change. They were still putting old half-pennies in the collection box, although these had been demonetised at the beginning of the year. "Níl maith ar bith a bheith ag iarraidh iad a thabhairt dona sagairt - ní fiu tada níos mó iad" he thundered. I was glad to be in the crowd at the back for fear he might turn to me for confirmation.

It was also that August that I wrote the article in Irish on Gold (An tÓr) for the Autumn Bulletin of the Central Bank. I had already introduced a short article in Irish into the Appendix to the Annual Report. This policy of having contributions in Irish on economic and monetary topics was continued during my term of office. I found, however, that I had to keep showing the good example myself! It is of interest that both the first of these articles (Summer 1969) and the last (Spring 1976) dealt with the question of parity of the Irish currency with sterling.

That August, too, a plane brought to Castlebar, and a car to Connemara, the Governor of the Bank of Ireland, Dr. Don Carroll, whom I was meeting to make arrangements for the transfer to the Central Bank of all the remaining net sterling assets of the Associated Banks.

We lunched at the Zetland Hotel, Cashel, and afterwards (to the obvious disgust of the Manager, who saw the quiet holiday atmosphere of the hotel being destroyed by business) we completed the deal. Then, having come to Carna for afternoon tea, Don Carroll set off for Castlebar and home. Cashel's tranquillity had already been upset that year by General de Gaulle; it was now able to relax again!

My holiday was, however, again disturbed. A packet arrived from Dublin which ^{seemed to me to} suggest that the Department of Finance was seeking statutory control over the exercise of credit policy by the Central Bank. The central issue of the relation between Central Bank and Government was being brought into focus. My successor in Finance, Mr. C. H. Murray, had forwarded a note which referred to the Central Bank's proposal that the new legislation should give the Bank the power to regulate credit by the prescription of "liquidity ratios" - a statutory power which the Bank sought in order to supplement the informal voluntary system, based on observance of guide-lines, which had proved in practice to be deficient, as explained earlier. The note pointed out that the ratios could have significant implications for credit policy and, while not questioning the desirability of more efficient methods of credit control, suggested that the proposed change raised the issue of whether the Government or the Central Bank had the ultimate responsibility for monetary policy. The 1942 Act provided for consultation between the Minister and the Bank but this was "only one side of the coin". Although the 1942 Act had reserved a few powers to the Minister for Finance, it was, according to the note, silent on the general question of the relative responsibilities of the Minister and the Bank in relation to monetary policy. The situation was otherwise in Britain, where the Treasury had a general power to give such directions to the Bank of England as, after consultation with the Governor, it thought necessary in the public interest, and where the Bank's "recommendations" to banks were binding only if authorised by the Treasury. The examples of Canada, Australia, New Zealand, and South Africa were also cited. In Canada, there was a statutory requirement that the Minister for Finance and the Governor should consult regularly on monetary policy and on its relations to general economic policy. Where there was a difference of opinion between the Minister and the Bank on monetary policy, the Minister might, after consultation with the Governor of the Bank and with the approval of the Governor of Canada in Council, issue a directive with which the Bank must comply. A similar position was said to exist in Australia. In New Zealand the Reserve Bank was required "to give effect as far as may be to the monetary policy of the Government" and could vary minimum reserve requirements only with the agreement of the Minister for Finance. In South Africa the Reserve Bank had to have Treasury consent before it could require the Commercial Banks to keep a supplementary reserve with it.

The note ended by asking whether a provision defining the Minister's, or the Government's, ultimate responsibility should be written into the new Central Bank Bill; what form it should take consistent with the maximum possible independence of the Bank "particularly in the day-to-day implementation of policy"; whether the provision should be general or relate only to the liquidity determining powers; and whether it should indicate the procedure to be adopted in the event of a disagreement over policy.

It seemed to me important to reply quickly and cogently, so I sent a manuscript letter as follows from Carna to Mr. Murray on 25 August:

" Your letter and memo. of 21 August were sent on to me here. I don't think any question concerning the ultimate responsibility for monetary policy is raised by the adding of a statutory power to prescribe liquidity ratios to the central banking functions the Central Bank is already given by S.7 of the 1942 Act.

It is, in my view, beyond question, and beyond any need of definition, that the Government exercises the ultimate responsibility for economic policy, of which credit policy is an integral part. The Central Bank is a subsidiary public authority with express responsibility for seeing that "in what pertains to credit the constant and predominant aim shall be the welfare of the people as a whole" and, for reasons which need not be elaborated but which I consider sound, it is given more independence in discharging this responsibility than a Government Department. The nature of this responsibility could not appropriately be described in any narrow sense of day-to-day administration of a credit policy determined by the Government. My view is that, considering both the effective application of the principle of subsidiarity and the long-term interest of Government, Bank and public, responsibility for deciding what kind of credit policy is appropriate from time to time and how to make it effective should rest with the Central Bank subject to broad conformity with national economic policy. In this context, it was agreed between the Minister for Finance and myself before I came here as Governor that, since incomes, public expenditure and credit policies were interrelated and needed to be co-ordinated, there should be frequent and frank interchanges of information and argument with a view to as sound a consensus as possible being reached on the lines of policy to be followed in the national interest.

What should happen if there is an irreconcilable difference between the Central Bank and the Government is a devil we need not bid "good morrow" to until we meet him, which I hope we never will. In the countries

mentioned in the memo. this devil had already been met or was looming into sight. In any case, neither the risks, nor the implications, of a fundamental disagreement would be lessened by a statutory provision. Should the contingency arise, the Government's capacity to enforce its overriding authority would not depend on such a clause being ready to hand. "

This did not lay the matter to rest. Mr. Murray, in what he described as an "interim reaction" to my letter, wrote on 18 September disclaiming any disagreement on fundamentals but expressing a worry ("if that is not too strong a word") lest the advantages of the present flexible position "might not be partly offset by a certain indefiniteness which might tend to obscure the relative roles of the Bank and the Minister". He accepted that there were many problems, and dangers, in attempting a precise definition of roles - and this was one reason why legislation might not be desirable - but suggested that there might be something to be said for a broad, general statement during the passage of the Central Bank Bill. My reply was that I thought the views I had expressed on 25 August could well form the basis of any general statement considered necessary but that I would be happy, if Mr. Murray so wished, to supply a draft statement for use in connection with the Central Bank Bill. In fact I sent him informally the following note on 7 January 1970:

Responsibility for Credit Policy

1. There cannot be anywhere in the world today where a Central Bank claims complete independence in the field of monetary policy. It is universally recognised and accepted that monetary policy is part and parcel of economic policy, the general direction of which is a Government responsibility. These statements are true whether or not they are given specific expression in central banking legislation. The ultimate responsibility of the Government in this country for economic policy, of which monetary policy is an integral part, is beyond question and scarcely needs statutory definition.
2. Within the context of ultimate conformity with general economic policy, central banks are everywhere intended to have a high degree of independence and discretion. The fact that they are constituted as public authorities on a different basis from Government Departments is evidence of this principle. The preservation in some sense of the

integrity of the currency and the regulation of credit in the interest of the community as a whole are responsibilities which can best be exercised if the central bank is sufficiently independent to be able to withstand day-to-day pressures from any source. There is general appreciation - even in countries where, for special reasons, the final authority of Government has been expressly defined - of the wisdom and utility of having an independent and responsible source of advice and comment on the part which monetary policy should play towards achieving national policy objectives. This role of a central bank is one of the "checks and balances" which are necessary and desirable to promote sound and efficient economic management. The quasi-independent position of the central bank also serves to re-assure foreigners, including potential investors.

3. In Ireland, the Central Bank is given by law (Section 6(1) of the Central Bank Act, 1942) the "general function and duty of taking (within the limit of the powers for the time being vested in it by law) such steps as the Board may from time to time deem appropriate and advisable towards safeguarding the integrity of the currency and ensuring that, in what pertains to the control of credit, the constant and predominant aim shall be the welfare of the people as a whole". The Central Bank would always have regard to Government policy in considering from time to time what steps were appropriate and advisable under this subsection and, in any case, the position of the Minister for Finance is expressly recognised in the immediately following subsection which reads:

The Minister may, on such occasions as he shall think proper, request the Governor on behalf of the Board or the Board to consult and advise with him in regard to the execution and performance by the Bank of the general function and duty imposed on the Bank by the foregoing subsection of this section, and the Board shall comply with every such request.

This puts beyond doubt that the Governor and the Board are answerable to the Minister for Finance.

4. In principle it is hard to see how any fundamental conflict could arise between Central Bank and Government as the general function and duty assigned to the Bank are amongst the aims of good government. In practice, of course, differences of interpretation could arise as to how the general function and duty should be discharged in a particular economic context. It is these that are provided for in Section 6(2), cited above.
5. Specifically, the Central Bank might have one view as to whether a particular rate of increase in prices or a particular size of external payments deficit or a particular intensity or incidence of credit control was reconcilable with its general statutory function and duty under Section 6(1) of the 1942 Act; and the Minister for Finance, or the Government as a whole, might

have another. In this event, and if consultation and advice under Section 6(2) failed to bridge the difference, the Governor and Board of the Central Bank would be forced to consider whether their continuing in office would be consistent with their statutory obligations.

6. Normal relations between the Central Bank and the Government therefore rest on the supposition that, in the determination of general economic policy, the Central Bank's views will be taken into account to the extent that the Bank will not find it impossible to reconcile its general function and duty under the 1942 Act with active participation in the carrying out, in the monetary field, of general economic policy. Responsibility for deciding what kind of credit policy is appropriate from time to time and how to make it effective must rest with the Central Bank, subject to broad conformity with national economic policy. It would be inconsistent with the degree of independence rightfully belonging to a central bank for any form of day-to-day or detailed supervision of the bank's administration to be exercisable by a Government Department or a Minister.
7. For this system to work it is essential that there should be frequent and frank interchanges of information and argument between the Central Bank and the Minister for Finance and his Department. These interchanges should cover the whole field of economic policy, including public expenditure, taxation and borrowing; incomes; prices and external payments. The fact that the Secretary of the Department of Finance is one of the service directors of the Bank helps to ensure a close and co-operative relationship; so also do the personal correspondence and periodic interviews of the Governor with the Minister for Finance.

It was arranged that I would meet the Minister on 14 January 1970. Mr. Murray was present. My note of the meeting runs:

" After a brief review and discussion of the economic situation, in the course of which I pointed to excessive money income and public expenditure increases as the basic problems and stressed the need for remedial action soon which would at least reverse the trend in the balance-of-payments deficit, the Minister referred to the increased powers which the proposed Bill would confer on the Central Bank and said he was considering whether, as in many other countries, there should be legislative provision for the issue of a directive by the Minister for Finance to the Central Bank to ensure conformity of credit policy with general Government policy. He mentioned that amending

legislation was very infrequent and that a provision of the kind he had in mind might be desirable looking to the long-term future. He invited my views.

I said that I would not be in favour of such a provision for the general reasons indicated in my manuscript letter to Mr. Murray last August. It was only in some countries (and in Canada for peculiar reasons which Mr. Murray and I explained) that such a provision appeared in central banking law. We already had a general statutory provision (S.6 of the 1942 Act) which not only placed the general function and duty on the Central Bank of doing what it could to preserve the integrity of the currency and to operate any control of credit with regard to the interest of the community as a whole but also gave the Minister for Finance the right to call the Governor and Board to account for their exercise of this general function and duty. It was already clear, therefore, that the Board were answerable to the Minister for Finance for the discharge of their statutory responsibilities.

I confirmed that the Central Bank recognised that, in a democracy, the Government elected by the representatives of the people bore the ultimate responsibility for economic policy, of which monetary policy was an integral part, but here as elsewhere it had been thought right to establish a subsidiary authority, differently constituted and with more independence than a Department, to be immediately concerned with monetary policy. This was to be seen as one of the "checks and balances" in the operation of the democratic system.

Normally, no fundamental conflict should arise between Government and Central Bank. The general function and duty assigned to the Central Bank of Ireland would also be amongst the aims of good government. Frequent exchanges of information and consultations should result in sufficient consensus on the broad aims of economic policy from one period to another for the Central Bank to be able to determine its credit policy in a way which conformed to national economic policy. Subject to this broad conformity, the Bank should be free to decide what kind of credit policy was appropriate and how to make it effective.

A critical factor in reconciling the Bank's responsibility with the pursuit of Government policy would be the balance-of-payments trend and the prospective effect on external reserves, since these had an immediate relevance to preserving the "integrity of the currency" in the sense of its exchange value. If a conflict were to arise it would probably relate to this factor. Even if the Minister for Finance had power to issue a directive to the Board of the Bank, this would not absolve them of their statutory or, indeed, their conscientious obligations. If the differences of views could not be reconciled after serious efforts on both sides, the Governor and Board would have no option but to resign. This was acknowledged to be the position e.g. in Canada. I quoted to the Minister the following extract from Governor Rasminsky's lecture in November 1966 on the "Role of the Central Bank Today":

"In order that the relationship between the Bank of Canada and the Government can be clarified in law, an amendment to the statute governing the Bank of Canada is now being considered by our Parliament. The amendment makes it clear that there must be, as there is now, continuous consultation on monetary policy between the Government and the Bank. It provides a formal procedure whereby, in the event of a disagreement between the Government and the Bank which cannot be resolved, the Government may, after further consultation has taken place, issue a directive to the Bank as to the monetary policy that it is to follow. Any such directive must be in writing, it must be in specific terms, and it must be applicable for a specified period. It must be made public. This amendment makes it clear that the Government must take the ultimate responsibility for monetary policy and it provides a mechanism for that purpose. But the central bank is in no way relieved of its responsibility for monetary policy and its execution. It can be assumed that if the Governor were directed to carry out a monetary policy which, in good conscience, he could not regard as being in the national interest, he would, after taking steps to ensure that the issues involved were placed clearly before the public, resign".

I told the Minister that, like a good Catholic, I recognised the supreme authority of the Pope but, like a good bishop, I claimed jurisdiction in my own diocese. The Minister disclaimed any desire to interfere with the administrative freedom of the Central Bank. No desire was expressed to require Ministerial approval for e.g. liquidity ratios to be fixed by the Bank. The special reasons for the Ministerial approval provided for in the 1942 Act were explained.

Finally, I pointed out that the economic prospect was particularly disquieting just now. It would, therefore, be most unfortunate if, however the Minister might try to relate it to possible future contingencies, the inclusion of a directive power in the Bill were interpreted by the public as implying some conflict already existing or imminent between the Central Bank and the Government. Suspicion would fasten at once on the security of the exchange rate and, as the Minister knew, patriotism counted for little if people with money thought it wise to protect themselves by an export of funds. For reasons, therefore, both of principle and expediency, I thought the Minister should drop the idea. If he still wished to go ahead, however, I would like to be able to consult the Board of the Bank and offer their views before any final decision were taken.

Mr. Murray suggested that the Minister might be content with making a general statement on the relative positions and responsibilities of Government and Central Bank on the second reading of the Bill. The Minister said he would reconsider the matter in the light of the discussion.

(Note: Mr. Murray later told me that the Minister had passed him back the papers without expressing any intention to proceed with the "directive" idea but with a request for a draft statement. At Mr. Murray's request I am preparing such a draft).

Mr. Murray confirmed, at Board meeting on 28 January, that Minister did not intend to proceed with the "directive" idea. The text of the Bill would be circulated within a week.

Mr. Murray sent me on 2 February, 1970, a short draft of final paragraphs for the Second Reading Speech on the Central Bank Bill which I confirmed to be satisfactory subject to the insertion of a reference to the "general function and duty" provision of the 1942 Act.

In fact, it was not until a year later (16 February, 1971) that the Minister's speech was made.* Meanwhile, on 16 June, 1970, he answered a Parliamentary Question about the answerability and autonomy of the Central Bank board in the course of which he said:

" Subject to the ultimate responsibility of the Government for national economic policy of which monetary policy is a part, the Central Bank is free, within the limits of the powers for the time being vested in it by law, in carrying out its statutory general function and duty (and he quoted the 1942 Act definition of this). He went on:

As Minister for Finance, I am authorised by the 1942 Act to request the Governor on behalf of the board, or the board, to consult and advise with me as regards the performance by the Bank of this general function and duty and the board is obliged to comply with every such request. In practice there are frequent consultations between the Minister and the Governor covering matters mentioned by the Deputy all of which are aspects of the bank's general function and duty."

The matters mentioned by the Deputy included "the quantity and nature of the bank's reserves, the nature of the bank's investments". Following a reference to the terms of the reply at the Board meeting on 17 June I wrote on 19 June to Mr. Murray saying that it would have been preferable had the reply stopped at the words "frequent consultations between the Minister and the Governor" as the remainder of the sentence was not strictly correct either in fact or in principle. "Matters such as the quantity and nature of the bank's reserves and the nature of the bank's investments have not been the subject of frequent consultation with the Minister nor should they be, as they are primarily matters of administration within the authority of the Board".

* Mr. George Colley became Minister for Finance in May, 1970 - see p. 423.

Mr. Murray's reply of 14 July, 1970, which argued that significant changes in the size or composition of the reserves, e.g. as a result of volatile inflows, would be a matter for consultation between the Minister and the Bank" ended by acknowledging that the agreed statement of relations between Bank and Minister for the purpose of the Second Reading of the Bill still held good. In fact, the following quotation from the Minister's speech on 16 February, 1971 shows his full acceptance of the Central Bank viewpoint; the words echo those which had been used in the Bank's submissions:

" The provisions of the Bill will add considerably to the responsibilities of the Central Bank. It is important that the bank should have the freedom and discretion, as well as the administrative competence, to enable it to discharge these responsibilities fairly and efficiently and with full regard for the public interest. I have every confidence in this respect in the bank's board and staff.

When the Central Bank was being established, the relationship between the Government and the new institution was considered, and the then Minister for Finance said in the Dail that:

" It is intended that there should be the fullest co-operation between the Government and the Central Bank. The Government does not, however, propose to interfere with the administration of the bank which will be independent in the carrying out of its functions. This independence is possessed by almost every Central Bank throughout the world and is a very desirable provision".

I have already mentioned the general function and duty described to the Central Bank by the 1942 Act which are to take "such steps as the board may from time to time deem appropriate and advisable towards safeguarding the integrity of the currency and ensuring that, in what pertains to the control of credit, the constant and predominant aim shall be the welfare of the people as a whole". This statutory function of the bank in relation to monetary policy does not, of course, diminish the ultimate responsibility of the Government in that sphere.

There can be no question about the responsibility of the duly-elected Government for national economic policy of which monetary policy is an important and integral part. The need for integrating monetary policy with general economic policy and the ultimate authority of the Government in regard to both are evident. They are fully recognised here and throughout the world.

At the same time, because of basic public interest considerations and historical experience, it has been recognised universally to be desirable to have a special institution, differing in constitution from, and enjoying more independence than, a Government Department, charged

with the immediate responsibility for monetary policy. I can think of no independent country in which there is not a Central Bank. In some countries the ultimate authority of the Government for national economic policy is expressly indicated by a statutory provision for the issue of a policy directive by the Minister for Finance to the Central Bank. Elsewhere, the ultimate authority of the Government, even though it may not be expressly defined, is nonetheless undisputed. Everywhere, subject to this ultimate need for reconciliation of monetary with general economic policy, the maximum independence and discretion is assured to central banks.

In our case the relationship between Government and Central Bank rests as much on mutual confidence as on statute. It is sustained by frequent consultations between the Minister for Finance and the Governor of the Central Bank on all aspects of economic policy, by a frank interchange of information and comment in the policy field and by the fact that the Government have an official representative on the board of the bank. It has worked well since the establishment of the bank in 1943. The bank has always had regard to national economic policy in considering monetary policy and I have no doubt that it will continue to do so. I do not regard the provisions of the present Bill as calling for any change in the basis of the present relationship. "

IV. ADVICE AND COMMENT, MARCH 1970-DECEMBER 1970

The economic tally for 1969 revealed it as a year of industrial unrest, rather slow growth (3%) and of sharp rises in non-agricultural incomes (13%), prices (7½%), consumption (11½%), and total public expenditure (18½%). Imports rose faster than exports and the balance of payments deficit expanded to over £60 million, with a disquietingly large increase in imports of consumer goods. There was, however, a net increase in employment and, for the first time, exports of industrial goods became the largest element in total exports. The tide of inflation was rising, with an ominous tendency for unit wage costs in manufacturing to rise faster in Ireland than in the U.K.

On 25 March, 1970, I wrote as follows to the Minister for Finance:

" I have not expressed any views to you on the economic position since 3 November last, when you were good enough to see me. With the approach of the Budget, however, it seems appropriate to offer some comments and suggestions related to the analysis and forecasting which has been going on here and elsewhere in recent months.

Large as the balance of payments deficit was in 1969 (with forces at work to make it larger still in 1970), the more deeply serious problem for the Irish economy is the relatively fast rate of increase in prices and unit costs of production. It is this outpacing of the U.K. and Western Europe in price and cost inflation which, if unchecked, will cause the greatest damage to economic development. By injuring the competitiveness of Irish goods, and of services like tourism, it will bring economic growth to a halt and not only bar the way to new jobs but eliminate many brought into existence, at great effort and cost, in recent years. If it were allowed to continue, this exceptionally high rate of price inflation - involving, in effect, a faster fall in purchasing power of the Irish pound than of the pound sterling, the dollar, the DM and other currencies - could cause a "fundamental disequilibrium" in the exchange parity context.

The unduly high rate of price inflation is largely due to domestic factors in particular to (1) inordinate income increases and (2) heavy tax increases to meet steeply rising public expenditure, itself partly the consequence of (1). There is, of course, an accommodating environment of excessive total spending (public and private combined), supported by bank credit and external borrowing. Tackling the problem, therefore, involves (1) doing something effective to moderate the rate of increase in money incomes,

(2) curbing the public expenditure increases so that tax rates do not have to be increased, or if they do, can be confined to tolerable increases in direct taxation, and
 (3) making sure that fiscal and monetary policies combine to produce a manageable rate of growth of total expenditure.

In view of the utter disproportion between the present rates of increase in money incomes and in national output, the road back to moderation will be difficult. It is much easier to narrow a gap of 4 to 5 per cent. than the present gap of about twice that size. Once a price rise of 7 to 8 per cent. appears, everyone thinks of it as an independent phenomenon, forgetting that it is just a consequence of a 15 per cent. a year increase in incomes against a rise in output of 5 per cent. The increase in the external payments deficit is another unrecognised consequence of this grave lack of balance between money^{and} goods. Much educational effort will be needed to bring home to all concerned the double advantage of reducing this imbalance by narrowing the gap between income and productivity increases: the individual would be at least as well off, because prices would rise less, while the community would be much better off because more of its goods and services would be competitive, more new jobs would be on offer every year, social investment could be raised, and emigration reduced.

The relatively fast rise in Irish production costs may already have begun to damage the growth potential of the economy. Industrial production was lower in the third quarter of 1969 than in the second (allowing for seasonality) and the trend seems to have continued downwards in the final months of the year. The need for remedial action is, therefore, urgent.

Price inflation has an inbuilt tendency to escalate. If an increase of 8 per cent. is expected over the year ahead, a minimum 12 or 13 per cent. increase in individual incomes seems the only way to overcome the inflation and have some real participation in the benefits of economic growth. Sectional greed and "drift" will inflate the average income increase. In consequence, the price rise, both actual and expected, will be carried to a higher level. To break this vicious spiral the rise in income must be held back long enough to enable productivity to catch up somewhat and thus slow down the rate of price increase. Then a more moderate rate of income increase, coming progressively closer to the rate of national growth, will unwind the spiral and restore reasonable price stability. It must be recognised that this will not happen of its own accord: the spiral has first to be broken by a concerted and comprehensive halting of all income increases for a significant period - probably at least a year. Acceptance of this by the trade unions, or at least their acquiescence, would be well worth trying for; but, if a voluntary "breathing space" is rejected or risks being destroyed by maverick action on the part of individual unions or groups, the Government should be ready to intervene to nullify any financial advantage which such action could initially confer.

The publication of the N.I.E.C. Report on Incomes and Prices is the obvious context in which to state the Government's future policy, not only on the principle of the N.I.E.C. recommendations relating to a voluntary incomes policy but also on the immediate need for a "breathing space" of a year to afford time for the consultations and other preparations needed to bring more rational and orderly arrangements into operation on this vitally important front. There would, I believe, be a wide measure of public approval of a Government initiative of this kind taken against the background of a frank explanation of the seriousness of present trends; and if the price of removing residual opposition were to be a "saver" for genuine 12th round cases (the Labour Court to decide which these were) and, perhaps, some concession for the "low-paid" during the "breathing space", this is a price that might be worth paying.

I know from Charlie Murray of the efforts you are making to curb the growth in public current expenditure in 1970/71 and I wish you success. Without a marked slowing down in the rise in incomes and public expenditure our economic future will be in great danger. "

On the afternoon of 7 April, as Chairman of the N.I.E.C., I saw the Taoiseach, Mr. J. Lynch, to present the N.I.E.C. Report on Incomes and Prices Policy. Afterwards, I called on Mr. Murray, who gave me details of the budgetary proposals. The following morning I sought an interview with the Minister for Finance to discuss the budgetary proposals but received a message to the effect that, having been in touch with the Taoiseach, I should not need to see him. This suggested annoyance at my having been in direct communication with the Taoiseach, so I wrote the Minister a personal note of explanation:

" I saw the Taoiseach yesterday afternoon to present the N.I.E.C. Report on Incomes and Prices Policy and to give him some personal views on it similar to those contained in my letter to you of 25 March. I had not anticipated that the Report would already have been circulated to the Government and a statement on it cleared. All I could do was to suggest that the idea of a "breathing space" might be considered as part of the Government approach to the proposed meeting with the I.C.T.U. and the Irish Employers' Confederation. I emphasised the vital importance for national development of getting back to a more moderate rate of incomes increase.

When I left the Taoiseach, I called on Charlie Murray (as he had asked me to do) to be given a "run-down" on the present state of the budgetary proposals. I explained why I was unhappy about them and asked him to pass on my

reactions to you. Becoming more unhappy overnight, I 'phoned him at 9.30 this morning to ask him to arrange for me to see you. I then thought it advisable to phone the Taoiseach and say that what I had heard about the budgetary proposals after seeing him would, I thought, create difficulties on the incomes side because of the major price effects. I told him I had already sought an interview with you at which I would be advocating more reliance on direct taxation and less additions to expenditure. He mentioned that he would be seeing you himself and would discuss the matter. And that's how it was.

I am genuinely worried about our economic prospects, the more so as I have the impression that you are tired of hearing from me. I am not by nature pessimistic and I am certainly not putting on some "Central Bank" act. "

The main cause of my anxiety was the proposal to double the turnover tax (making it 5% instead of 2½%) and thus deliberately add 3% to a price rise which looked like being at least 6% without any tax increase in 1970.

The Minister relented and received me on Monday morning, 13 April. I expressed my views to him both orally and in the form of manuscript notes which I handed over to him. The gist of my comments, as put on record the day after the Budget (23 April), is given below:

" The proposed level of public expenditure, capital and current combined, probably entailed an increase as large as last year's record. The methods of financing contemplated heavy borrowing at home and abroad and large additions to prices. The budget would have no disinflationary impact, though disinflation was needed to slow down the rise of prices and incomes and turn the external deficit back from a threatened £90 million to some £50 million.

Budgeted current expenditure would be some £64 million over 1969/70 actual, which itself was nearly £19 million above the 1969/70 budget expectation. The budgeted increase for 1970/71 was 15½ per cent as against 11 per cent expected in the 1969 budget. There was a continuous history of underestimation at budget time. The risk of underestimation was accentuated by the current high rate of price and cost increases and by the severity of prebudget "cuts".

Admittedly, budgeted capital expenditure showed a smaller increase (£2.7 million) than the original figure for 1969/70 did over the previous year's estimate. The inclusion of a contingencies provision might offset the recent tendency for actual expenditure to exceed the provision.

However, current and capital expenditure combined showed a budgeted increase of £85 million over last year's actual. Correcting this for underestimation on the current side, the actual increase in 1970/71 was likely to be as great in absolute (and, perhaps, in real) terms as the £90 million recorded last year, when £65 million was expected. The actual increases in 1967/68 and 1968/69 were £46 million and £79 million, respectively.

The capital budget showed a residual exchequer borrowing requirement of £75 million as against £60.9 million actual (and £53 million expected) in 1969/70. Only £15 million of this could be raised by external borrowing if Associated Bank credit was to increase by £75 million and yet the balance-of-payments deficit be reduced to about £50 million. The raising of the rest would pre-empt a great part of available domestic credit.

As regards the current budget, the buoyancy of tax revenue (£42 million* or 12 per cent.) seemed overestimated in relation to a projected return to a £50 million external deficit, a 10 per cent. increase in national income and a lower rate of increase in personal expenditure than in 1969. Buoyancy should be a good deal less than in the inflationary year 1969/70 and it would be safer to take off £5 million at least.

A voluntary incomes policy - in particular, the vital "breathing space" of little or no change for a year or so after the 12th round was completed - would stand no chance if by a budgetary decision the Government deliberately added 3 per cent. to a price rise which was 7½ per cent. in 1969 and looked like being at least 6 per cent. without any tax increase this year. It would be only too easy for public opinion to be inflamed, to the advantage, of course, of the political opposition, but also of subversive groups and of irresponsible, disruptive elements amongst the workers. The doubling of turnover tax would excite more criticism on economic and social equity grounds than a combination of income tax increases and specific increases on items that still "came up smiling".

The reasons for expecting a price rise of at least 6 per cent. this year without any tax increase were:

- (a) even a continuation of the December-quarter 1969 price level would involve almost a 2 per cent. increase for 1970 over the 1969 average.
- (b) an import price increase of, say, 4 per cent. would add nearly a further 2 per cent. to the domestic price level in 1970.

* The final budgetary figure was £43.4 m.

- (c) the rising gap between income and productivity increases could raise the domestic price level by 3 per cent. or more.

If the price rise was not greatly to exceed last year's $7\frac{1}{2}$ per cent. it was important to keep the price effect of any increases in indirect tax rates to a minimum - not more than $1\frac{1}{2}$ per cent. The public probably expected to have to face another price rise of last year's dimensions but inflationary psychology would get a big boost if 9 or 10 per cent. looked likely.

The rate of increase in public expenditure was greater than was allowed for in the provisional credit policy guidelines (to be published later that week) and these might need early adjustment downwards unless income trends were significantly moderated, a prospect doubtful enough but likely to be shattered by any major Government-generated addition to prices.

I strongly suggested, therefore, that the current budget proposals should be recast so as (1) to reduce the over-liberal allowance for buoyancy of revenue, the more so as there was no allowance for excess current expenditure, (2) to modify the additions to expenditure and (3) to obtain from direct taxation more of the extra revenue needed so that the price impact, in fact, would be moderate. I outlined in detail how this recasting might be done. "

The Minister promised to consider what I had said but gave me no reason to hope that his proposals would be changed. His line seemed to be that, if an extra £20 million or so had to be obtained, it was more straightforward and effective to obtain it by doubling the turnover tax and he doubted whether the reaction of wage and salary earners would be significantly different from their reaction to an increase in income tax and various specific duties. On the latter point I strongly urged a contrary view.

I referred to the desirability of adequate consultation before budgetary proposals were finally settled so that monetary policy could be properly co-ordinated with fiscal policy and I left with the Minister a copy of the written understanding on this point which we had reached before I left Finance for the Central Bank. I also left with the Minister the notes I had recently compiled on the reasons for avoiding a devaluation.

The notes on devaluation (signed by me and dated 8 April, 1970) had been prompted by the fear that a progressive deterioration in competitiveness might be under way, if unit costs continued to rise faster here than in the U.K. It may be of interest to reproduce them here.

Some reasons for avoiding a devaluation

- (1) A devaluation would turn the terms of trade against us. We would have to produce (and sell abroad) a greater quantity of goods to earn the same amount of foreign exchange as before. In other words, devaluation would depress the international value of our domestic effort on farms, in factories, hotels, etc. There is no obvious advantage in this.
- (2) If the international value of our productive effort is, in fact, less than we are trying to pretend, devaluation may be forced on us by inability to compete at the present rate of exchange. The alteration of the exchange rate is then merely a market adjustment which makes our goods and services cheaper for foreigners, and foreign goods and services dearer for us, and so tends to bring about a better balance between payments out and in.
- (3) After nearly 50 years of a separate Irish currency equal in value to sterling - following a century of common currency - it would not be a source of national pride to have to admit that the Irish pound could no longer look even a depreciating pound sterling in the face. If there were a national advantage to be gained, this would be justification enough. But it is clear that the circumstances which would force us to devalue would imply, not deliberate pursuit of some tangible advantage, but rather recognition of failure to overcome a competitive disadvantage caused by relatively fast inflation and inadequate productivity growth.
- (4) Devaluation in the circumstances just mentioned might provide no more than temporary relief. We would be submitting to events, not trying to guide them, and the forces which made devaluation inevitable could be strengthened, rather than moderated, by this surrender. Prices of all imports would be raised, with serious effects on the cost of living in an economy so dependent on imports, and with the exchange rate, the only peg in the economic framework, established as a moveable one, there would be little to stop a further spiralling of wages, prices and costs, necessitating in time a further devaluation. There can hardly, in Irish circumstances, be a "once for all" or a "trial run" devaluation. The first devaluation would be much more likely to start a chain reaction.
- (5) The flat, overall adjustment of relative prices of imports and exports which a devaluation effects is not necessarily, indeed is unlikely to be, the one best suited to the economy. Devaluation can be of benefit to forms of production which need, for expansion, to be more competitive pricewise in foreign markets. This does not, by and large, apply to agriculture.

In industry, many products may not need to be cheapened in that way because external price competitiveness may be adequate to maintain the desired rate of growth. In their case, devaluation would merely impose on producers the problem of maintaining the old external prices. For others, it would be a question of negotiating new intermediate external prices. Only a minority of sellers might want to take full "advantage" of the reduction in the foreign return for their goods. On the import side, the extra cost would apply equally and indiscriminately to capital goods, raw materials and the most inessential consumer goods.

- (6) A devaluation would considerably alter the present social balance, not necessarily in the desired direction. Farmers would benefit as against social welfare recipients and others pinched by the living-cost rise. Profits in the aggregate would probably benefit at the expense of personal earnings and there would be a redistribution of profits among firms. To stop the relief afforded by devaluation from being cancelled by a wage and salary "hike" a tight regime of incomes restraint would have to be enforced. A universal - and most inconvenient - foreign exchange control would also have to be introduced to safeguard the process of settling-down to the new parity. Getting value for devaluation would require a wide range of restrictive and unpopular measures. More value can be got by taking the necessary corrective measures in time and avoiding a devaluation. Exchange rate adjustment is no real substitute for internal economic discipline.
- (7) A most regrettable effect of a devaluation would be to confer a bonus on all those who had ignored the nation's needs in the past and invested their savings abroad. Apart from this effect (which would call for some countervailing taxation measure), the inability to control inflation, which would be seen as the root cause of a devaluation, would seriously impair the confidence of external investors and cause a cessation of the valuable capital inflow, if not, indeed, a substantial outward capital movement. Externs would lose what they have come to regard as a fixed point of reference in the Irish economy.
- (8) The inconvenience of a change in the long established parity with sterling would be a hindrance to the growth of trade and tourism. Such a change would also be politically undesirable as representing a divisive 26 Counties initiative. The currency parity, and the extensive circulation of this State's notes and coins in Northern Ireland, have hitherto been amongst the welcome symbols of potential unity. "

On 16 April 1970, I sent the Minister a copy of the provisional credit advice which the Central Bank proposed to issue on 18 April for the year ending April 1971. This advice - envisaging some restraint and a stabilisation of consumer credit so as to keep the external deficit to about £50 million - was "provisional" not only because it anticipated the budget but also because the dispute affecting the Associated Banks, which had begun in February, made it impossible to see whether specific restrictions would be observed or would remain appropriate. It had become extremely difficult to apply monetary policy just when it was most needed. The bank dispute was to result in closure of the Associated Banks in May and was to last until November: its financial and economic effects were analysed in a special booklet of which Dr. McGowan of the Bank was the author.

With the letter of 16 April I also sent the Minister a set of notes which, I suggested, he might find useful for his meeting with the ICTU and the Irish Employers' Confederation the next day. The notes were concerned with employee incomes, which as the letter remarked, accounted for about 60 per cent of total incomes. The Government's guideline of a 7 per cent increase for 1970, announced the previous December, was under pressure. The letter indicated that forms of income other than wages and salaries would obviously have to be covered by any "breathing space" or percentage limit policy.

The notes gave succinct and specific expression to principles put forward not only in interviews and correspondence with the Minister but in the Central Bank's Spring Bulletin, which had advocated, as the immediate aims of incomes and prices policy, containing the "12th round" and "arranging that further income increases are delayed long enough to allow competitiveness to be regained and are of a moderate order when they do occur".

The notes were as follows:

Notes for meeting with ICTU and Irish Employers' Confederation

The most critical problem facing the Irish economy is the present high rate of inflation. It is true that there is inflation almost everywhere. The unpalatable fact is, however, that the degree of inflation in Ireland is greater even than in the U.K. and much greater than in the EEC countries generally. It is urgently necessary to correct this. The recent NIEC report on Income and Prices Policy gave it as the unanimous view of all the members of the Council "that if the current rate of domestic inflation is not curbed even the existing level of employment cannot be maintained and it is utterly unrealistic for the Irish community to aspire towards full employment . . ."

A major factor in the relatively high rate of inflation in Ireland is the completely disproportionate rate of increase in money incomes as compared with productivity. Productivity had been increasing for some years at an encouraging rate but recently we seem to be running out of steam on this front, unfortunately at the same time as income increases have been magnified.

Evidence of how far out of line we are getting as compared with other countries is given in the NIEC report just published (Friday 17 April) on "The Economy in 1969 and the Prospects for 1970". In a footnote on page 7 the following information is given

- * "The percentage increases in unit wage costs in the Irish mining and manufacturing sector and in roughly comparable sectors in certain other European countries between the third quarter of 1968 and 1969 were as follows:

Ireland	...	...	...	...	...	11.53 per cent.
U.K.	...	...	...	...	...	3.45 per cent.
France	...	...	...	...	...	1.28 per cent.
Germany	...	...	...	...	...	1.91 per cent.
Italy	...	...	...	...	...	7.45 per cent.

- * Source: OECD Main Economic Indicators March 1970.

Similar evidence appears in the Credit Policy chapter of the Central Bank's Spring Bulletin, from which the following is taken:

"After a year in which the general level of prices rose in Ireland by 7½ per cent. - more than in any other OECD country except Iceland - the 1970 prospect is for a further increase in prices of a similar order. Demand and cost pressures are such that, even with a widening gap in the balance of payments, price increases in Ireland are outpacing those generally experienced in other countries and the competitiveness of Irish goods and services is being undermined. The impact on exports, on tourism and on employment and economic growth, though delayed and blunted for a time by efforts to hold existing markets,

cannot but assume grave dimensions if the present rate of inflation continues. How much Ireland is out of line is indicated by the following estimates of price increases in 1969 and prospective increases in 1970:

Changes in General Price Levels (G.N.P. Deflators)

	1969	1970
Ireland	7½%	7%
United States	4¾%	4%
Canada	4½%	4%
Germany	3%	4¼%
United Kingdom	4¾%	3%
Italy	3¾%	4¾%
France	6½%	5¾%
Japan	5%	4¾%

The NIEC report itself will do nothing immediately to solve this problem. It points up the dangers of a continuation of present trends and suggests institutional improvements which may lead towards less damaging trends in incomes and prices. Meanwhile, however, the dangers are with us and could well cause a major crisis before a voluntary incomes policy has time to take effect.

It seems desirable to stress not only the dangers of a continuation of present trends but, even more perhaps, the advantages to the individual and to the community at large of reverting to a closer relationship between increases in money incomes and national productivity - real increases as good or better than before for the individual, expanding exports, rising employment, less emigration.

It is of vital importance that the rising spiral of incomes and prices be arrested to enable productivity to catch up somewhat and thus slow down the momentum of inflation. The only way this can be achieved is by having a concerted all-round suspension of income increases for a significant period - at least a year - after completion of the 12th round. This breathing space can be said to be necessary even to afford time for the consultations and other preparations needed to bring more rational and orderly arrangements into operation in regard to incomes and prices.

Reasonable people would understand that, to protect acceptance of (or acquiescence in) such a "breathing space" against maverick action on the part of individual unions or groups or unwarranted price increases, the Government would have to be ready to intervene to nullify any financial advantage which such action could initially confer. To that extent "sanctions" may have to be invoked but it would be better not to put this possibility in the forefront in any discussions.

A complete cessation for a year of income increases may not be possible for a variety of reasons. Nevertheless, this might be the opening negotiating position. A fallback position might take the form of recognising the practical necessity,

as from the expiration of 12th round agreements (whatever the date of expiration may be) to concede a 5 per cent. increase for the subsequent year as a transition to the full operation of a voluntary prices and incomes policy. This 5 per cent. would be of the order of the interim settlement already recommended by Professor Chubb for the maintenance men when their present agreement expires on 30 June 1970 (and, according to today's press, rejected by them). His recommendation refers, however, only to a six months' period and it would be desirable to have this extended to a year. The Department of Labour would be in the best position to define an appropriate formula for the fallback position. One of the awkward - but not insuperable - problems is that all 12th round settlements (assuming these began with the Electrical Contracting settlement of October 1968) will not expire on the same date, e.g. the maintenance men's expiry date is 30 June 1970, whereas the building workers and electrical contractors' employees go to 31 December 1970 and the E.S.B.'s recent offer envisages the last phase of the 12th round running from 1 January 1971 to 30 June 1971.

On the morning of Budget Day (22 April) the news came that Mr. Haughey had been seriously injured in a riding accident near his home. His speech was read for him by the Taoiseach. Although the thought occurred to me, it seemed both too late and too naïve (given collective responsibility) to press the Taoiseach to use the Minister's personal mishap as a ground for postponement and reconsideration of the budgetary proposals! While the Minister was still out of commission the Arms Scandal broke. Mr. Haughey was dismissed from office, tried for his alleged complicity, but acquitted. It was only much later, when the Fianna Fáil Party was in Opposition, that he was restored to the front bench. The Finance portfolio passed to Mr. George Colley T.D. in May 1970.

The 1970 budget, it may be briefly recalled, doubled the turnover tax, gave income tax reliefs, improved social welfare payments and pensions, aided agriculture and raised both current and capital expenditure.

I was received by the new Minister on Tuesday, 2 June and my note of that interview (a copy of which I sent to the Minister who confirmed its accuracy) reads as follows:

" I told the Minister that I had brought with me a folder containing copies of some documents relating (a) to the question of liaison between the Central Bank, the Department of Finance and the Minister for Finance and

(b) to the advice which the Central Bank had been tendering over the past year. The Minister appeared to be acquainted already with at least two of these documents - my minute of 12 February 1969, written before I left the Department of Finance dealing with the relationship and my record of a pre-budget interview with the former Minister for Finance on 13 April 1970. I described my minute of 12 February 1969, which had been endorsed by Mr. C. H. Murray and the then Minister for Finance, as a form of "covenant" establishing an effective and useful relationship based on interchange of information and argument and reasonably frequent meetings between the Governor and the Minister, Secretary and other senior officers of the Department of Finance. The Minister indicated his agreement with this approach. He said that normally he would like the Secretary of the Department to be present when he received me but he did not exclude the possibility of occasions arising when he would see me alone at the instance of either of us. I expressed complete satisfaction with this arrangement but suggested that it might be desirable to have a settled procedure for periodic meetings so as to avoid the "drift" which could occur if all meetings were arranged ad hoc.

I then gave a short general review of the economic situation. I began by stressing the importance of the confidence factor. Many problems would be easier to solve if the Government were seen to be taking the situation effectively in hand. There was feeling abroad that, by reason of other preoccupations, the state of the economy had not received sufficient attention in the course of the past year. The balance-of-payments situation was serious enough - and was probably stopped from becoming worse only by the temporarily disinflationary effect of the cement workers' strike - but the really disquieting factor was that, as distinct from occasions in the past, the external payments deficit was now due in part to a relatively fast rise in prices and costs in Ireland as compared with Britain and other countries. A deficit due to excessive demand arising from public or private spending was less difficult to deal with than a deficit due to a loss of competitiveness. It was urgently necessary to reduce the present rate of price and cost inflation in Ireland.

Although the external reserves were high, the economy was vulnerable, being so dependent on exports for expansion and on external capital to promote investment. A failure of confidence, either abroad or at home, could quickly make serious inroads into reserves and there was no effective barrier which could be thrown up without new legislation. It was a statutory obligation of the Central Bank to redeem in sterling any Irish legal tender notes presented at its London Agency, the Bank of England. The continued inflow of foreign capital, as well as the ability of the Government and State bodies to borrow abroad, depended very much on the maintenance of confidence in the Government's determination to manage the economy efficiently.

Looking at the three main policy areas - fiscal, monetary and incomes - I said that the Minister would not be surprised to hear that I was dissatisfied with the recent Budget, regarding it as being inflationary rather than disinflationary. It would be impossible, I feared, for the Central Bank not to express some critical view of the Budget in its Annual Report but naturally we would try not to make this too sharp. It seemed as if all that could be done now was to make absolutely certain that no deficit - preferably, indeed, some surplus - would be produced on the current account of the Budget and that expenditure would be held down as far as possible. There was a special problem this year of very large-scale debt redemption. The holders of Government stock had it within their power to disrupt both fiscal and monetary policy by insisting on cash redemptions and spending the proceeds. Here again, stability and confidence were essential to a successful outcome of conversion operations when they could be undertaken.

As regards credit policy, we were in a state of frustration because of the bank strike and could only hope that what was going on during the strike would not be as much in excess of the guidelines as had been the case on the previous occasion. To assist in safeguarding the situation some element of currency scarcity should be maintained in the hope of restraining the excessive accumulation of creditor - debtor relationships.

On the incomes policy side the Government had, of course, accepted the NIEC Report in principle and had actually set up the new employer-labour organisation. In a sense, however, this was dressed up with nowhere to go until guidelines had been set for it by the NIEC. It was, therefore, particularly opportune that the NIEC should now be transformed into NEC, with some refreshing and expansion of personnel. The Minister told me that he was on the point of submitting a memorandum to the Government on this subject. In view of the obvious difficulties about statutory enforcement of guidelines I suggested that ingenuity might be directed towards finding some worthwhile incentives or rewards for their consistent observance.

I confirmed from the Minister that the Central Bank Bill is on the projected list of legislation for this session and that he hoped it might be possible at least to take the Second Reading.

I also suggested to the Minister that at his convenience he might wish to visit the Bank and meet the Directors and senior staff.

The interview concluded with my bringing the Minister up-to-date regarding our note printing and accommodation problems and the plans we have for meeting them. "

The new Minister, as was to be expected, was receiving advice also from his own Department and was himself conveying a fresh appraisal to his Government colleagues of the economic situation and the public finances. I received copies of the

relevant memoranda from Mr. Murray and sent him a personal note jibbing at a sentence about "action taken in recent months in the fiscal . . . and incomes policy spheres to damp down demand". I said tartly "I don't think there has been any such action (rather the contrary!) and I hope the Government won't lay any balm to their bosom on this score".

Before going on leave for August I sent the Minister (on 31 July) a memorandum entitled "Suggestions regarding Economic Policy" in the hope, as I said in the covering letter in Irish, that these views and recommendations would be a help to him when he was considering what needed to be done to regain control over our economic affairs. I confessed I had little hope that the Trade Unions could be persuaded to accept voluntary incomes restraint. The memorandum reads as follows:

Suggestions Regarding Economic Policy

1. The Policy Problem

Since the beginning of 1969 Irish prices have been rising at an exceptionally fast rate by international standards. Keeping export prices competitive is becoming increasingly difficult because of the rate at which labour costs are rising and the extent to which profit margins have already been reduced. Evidence is accumulating of loss of export orders by the clothing and textile trades in particular. The ratio of imports to national production increased markedly in the last two years, a development for which domestic price rises have been partly responsible. Irish products which substitute for imports are becoming difficult to sell on the domestic market. Economic growth has slowed down, as is indicated by the figures for industrial production in the latter half of 1969 and the first quarter of this year. Unemployment was substantially higher in May and June to an extent not wholly attributable to strikes.

2. The inflation has a predominantly domestic origin. On the demand side, the expansionary effects of Government spending (which is completely disproportionate to the rise in national output), added to buoyant private-sector spending out of inordinate income increases, have made it impossible to do much to correct the situation by credit policy. Pressures for increased incomes in the 12th round met with little resistance: employers preferred to increase wages, and take their chances on being able to increase prices, rather than face an industrial dispute. Increased pay, as well as deliberate additions to public expenditure, have necessitated higher taxation which,

being indirect, has raised prices further. The inflationary process shows no sign of coming to an end. Consumers' demand was buoyant in the early months of this year and any fall-off in this or in investment, due to the cement strike and the banks' closure, will be temporary.

3. The Remedies Available

The problem must be attacked from both sides - from the side of expenditure (demand) and from that of incomes.

Reducing the pressure of demand involves, primarily, Government action to lower the growth rate of public-sector spending and the associated borrowing requirement.

Credit policy, too, must be restrictive: any inappropriate addition to credit during the bank closure or any unanticipated foreign borrowing will need to be compensated for by revised credit policy advice.

These fiscal and monetary measures would reduce the growth rate of expenditure and, after some time, would lower the rate of price increase to something closer to international experience. They would also help to reduce the balance-of-payments deficit on current account which otherwise will make its delayed upward jump later this year and in 1971.

Neither monetary nor fiscal policy can, however, do anything immediately to improve relative costs or competitiveness: in this respect, they operate indirectly, and after a time lag, through their effects on expenditure, on employment, and on the disposition to press claims for inordinate income increases. Slower growth and rising unemployment can be avoided only if a disinflationary demand management policy is accompanied by a slowing-down of the rise in incomes. An effective incomes and prices policy is, therefore, the second wing of the attack on inflation. It is a direct means of seeking that competitiveness which will ensure expansion of sales, output and employment.

4. Suggested Combination of Measures

There is a general public feeling that the present rate of price increase (probably 9 per cent. for 1970 after 7½ per cent. in 1969) is intolerable and an appreciation that it will, if maintained, lead to serious economic difficulties. A combination of measures which promised to moderate the trend of price increases while maintaining employment and growth would probably, therefore, be accepted even though it meant a reduction in money income increases. The required policy action should be timed for the early Autumn of 1970 and should combine demand management with control of incomes and prices:-

1. Fiscal(a) Government current expenditure and taxation

- (i) A special Autumn budget to ensure, primarily by expenditure control rather than tax increases, that current expenditure in 1970/71 does not outrun current revenue and that it lags behind current revenue in 1971/72 so as to produce a worthwhile surplus to help finance a more limited growth in capital expenditure.
- (ii) Announce there will be no Spring budget in 1971 on the basis that the Autumn budget of 1970 will settle the taxation position until end-1971 and that current expenditure must be so tailored as to be more than covered by the revenue thus produced. This will both relieve the public mind and sidestep the claims for additional grants and subsidies, new services etc. to which an ordinary budget exposes the Government.
- (iii) Since a reduced rate of public expenditure increases is the crucial requirement, the taxation increase to achieve (i) and (ii) should be moderate. It should be mainly, if not entirely, direct. An increase in income tax should be enacted this Autumn to take effect as soon as possible.

(b) Government capital expenditure

The objective here should be to reduce the residual borrowing requirement (from banks and abroad) well below the £70 million level which entails excessive pre-emption of domestic credit at the expense of private sector needs and/or foreign borrowing, which has the same effect as extra credit creation on the balance-of-payments position. Control of demand pressures requires the limitation of public capital outlay, however financed.

2. Credit

No increase in bank credit except for productive purposes (and minimum Government needs), a policy which would provoke less opposition if the Government's demand for credit is reduced as recommended at 9(b) above.

3. Incomes and Prices

Taking into account the "carry-over" effect (estimated at 7 to 8 per cent. in 1971) of increases already granted or under way (i.e. 12th round phased increases falling due in 1971) and the effect on the national price level (estimated at 2 to 2½ per cent. in 1971) of the trend in import prices:

- (i) Impose a statutory prohibition on the payment by employers of any further income increases (i.e. beyond those provided for in current agreements) between the date of introduction of the legislation (the Autumn budget day) and 31 December 1971 except such increases - not in any case to exceed, say, 30/- a week - as the Employer/Labour Conference (or the Labour Court) may certify as not involving for the workers in question an excess over rates of increase established for other workers in the 12th round. This is intended to secure that, where an existing 12th round agreement provides for a phased increase in 1971, this will be the only increase allowed for that year; while prospective 13th round increases (such as building and electrical contracting workers may expect on 1 January 1971) will be replaced for the year 1971 by increases within a 30/- a week limit which can be categorised as merely bringing early participants in the 12th round into line with the higher norms later established in that round.
- (ii) A statutory prohibition should also apply for the same period to increases in dividends, professional fees and charges, percentage profit margins etc.
- (iii) Impose a complete freeze on prices except where import cost increases (or indirect tax increases if any) are considered by the price control authorities to justify such an increase. Domestic cost increases to be offset by productivity gains or at the expense of profits.

These could be expressed as temporary measures pending general agreement on a voluntary incomes and prices policy and its being put into effective operation by end-1971.

5. Likely economic effects

If the actual increase in money incomes in 1971 is held to a 7 to 8 per cent. average (as would roughly be the effect of allowing 12th round agreements to be observed and complemented but postponing any 13th round settlements as such), if import but not domestic cost increases are allowed to be passed on, and if there is no change (or only a small Autumn budget change) in indirect tax rates, the price increase from end-1970 should not exceed 4 to 5 per cent., the national growth rate should be at least 3 per cent., real incomes in 1971 would increase at this rate, there need be no reduction in employment, and the balance-of-payments deficit would be reduced. Confidence would be re-established to the benefit of investment and development. "

These suggestions conveyed in a more concise and specific form the advice given in the General Review section of the Annual Report of the Bank which had been submitted to the Minister for Finance on 15 July 1970. It is unnecessary, therefore, to reproduce any of the Review except for a few passages which explain further the Bank's attitude to a pay pause and remedial action.

The suggestion of a pay pause on completion of the 12th Round pay agreements was based on the desirability of slowing down the inflationary momentum. "If competitiveness vanishes because of rising prices and costs, the rate of increase in national production will drop, jobs will be lost and all sections of the community will suffer, especially the weaker sections". The argument for at least a six months' pause was that, associated with appropriate fiscal and monetary policies, "it would provide a short interval in which productivity might make good some of the competitive ground now being lost and the machinery for a voluntary incomes and prices policy could be put into working order". It was not a pay pause only that was being suggested - "a temporary restraint similar to that agreed in the wages and salaries context should apply to percentage profit margins, dividend distributions, rents, fees and similar forms of income". "What is being suggested is a purely interim arrangement leading to a more rational and orderly system of change in incomes and prices. It is obvious that social and economic patterns cannot be frozen - in particular, the distribution of incomes between categories and individuals must change - but it is in the community's interest that means be found of effecting necessary changes with minimum economic and social stress".

That Autumn the search went on for agreement on a moderate rate of increase in employee incomes. When the Employer/Labour Conference (which had been established in May, 1970) failed to produce a settlement, the Government decided to act and it was announced on 16 October, 1970, that from that day statutory control would be exercised over all forms of income and the machinery of price control would be strengthened. When the Dail reassembled legislation would be introduced to confirm a limit of 6 per cent on all increases in pay whether arising under new agreements or instalments of old agreements, or both, in the period to 31 December, 1971. The possibility of a Supplementary Budget was indicated. The Government had held

back as long as they could to afford every chance for an economically acceptable settlement to be reached voluntarily and were now intervening reluctantly, following repeated warnings to all concerned that a breakdown in voluntary efforts to solve the problem must lead to Government intervention.

The prices and incomes legislation was introduced when the Dail reassembled and the Second Stage was fixed for 10 November. Meanwhile, renewed efforts were being made to reach an acceptable voluntary settlement. The Government announced on 30 October that to facilitate these, one change was being made in the Bill - the provision for a 6% limit would be deleted and, instead, the Bill would provide that the increases to be allowed from 16 October would be such amounts as the Government might by order determine, these to have regard to the further discussions between ICTU and employers' representatives. The statement concluded with the injunction that "the essential requirement remains that income increases in 1971 must markedly reduce inflation and moderate the rise in prices".

In fact, a settlement was reached in further discussions and the Government, though less than happy with its terms, withdrew the proposed legislation because of "its preference for a voluntary rather than an imposed solution".

I had almost forgotten to mention that a Supplementary Budget was introduced on 28 October, a pardonable lapse since its economic effects were not significant. It provided formal opportunity for the Government to explain to the Dail and the public its anxiety about current economic trends and the urgent need for incomes restraint. The taxation imposed would yield only £11 million in a full year: the maximum combined rate of income tax and corporation profits tax on companies was raised from 50 per cent to 58 per cent and an increased rate of wholesale tax was levied on "luxuries" (yachts, motor cars, caravans, radio and television sets, etc). Clearly, these were cosmetic adjustments or, as the Minister more staidly put it "a rational and necessary supplement to the prices and incomes policy".

Two other proposals, which the Government doubtless saw in the same light, drew the fire of the Central Bank and in the end were not proceeded with.

The first concerned a recommendation which the Department of Finance had made to the Government that, if the Government approved in principle of the taxation of wealth, it should make an early announcement that such a tax was on the way. This was obviously conceived as an inducement to trade union members to accept wage restraint. The Central Bank received notice of this proposal only on 29 October, although it had been put to the Government on 26 October. My instant reaction on receiving Mr. Murray's letter was to write that having read it, and without saying anything as yet on the principle of such taxation, I wished immediately to express the strongest reservation about the proposal to make an early announcement if the Government were to approve in principle. "Public notice that such a tax, of unspecified scope and form, would apply from a future date would, in my view, risk setting in train a massive outflow of funds . . . It would be folly to add deliberately to the grave risks we already face".

I also protested at the lack of prior consultation with the Central Bank, remarking that "the arrangement for frequent and timely interchange of information and views on budgetary and other matters - under the "covenant" outlined in my minute of 12 February 1969 - is not, I fear working ideally".

So strongly did I feel that a vague advance announcement of a wealth tax would be asking for trouble that I risked Ministerial wrath by alerting the Taoiseach directly to the danger. "Don't bring unnecessary trouble on your head" I urged in a personal note.

Mr. Murray sent me a placatory letter on 30 October explaining the circumstances of the urgent submission to the Government to which I replied as follows on 2 November:

" I have read with much personal understanding your letter of 30 October.

In the interest of the Central Bank as an institution I am, however, still concerned and would like to explain why. The difficulties which arise when critical financial matters have to be urgently considered are recognised (and by no one better than myself) but it is precisely in these circumstances that proper consultation with the Central Bank is most desirable, i.e. consultation which affords some time for consideration and discussion before decisions are made or proposals put to the Government. Brief oral indications of what is afoot are not (as I am sure you would agree) a satisfactory form of "exchange of information and argument". The Central Bank's views may not, in fact, be accepted (as happened, for example, in relation to the April budget and the original announcement on incomes restraint) but for the Bank the opportunity it had to express them at least enabled a responsibility to be discharged.

You did mention to me on 23 October that consideration was being given to the question of taxing wealth but until I received the memorandum I had no idea that a proposal had been made to the Government to give over a year's notice, of an indefinite nature, to the public. I remain strongly of the view that this would be most inadvisable and I am glad that you are bringing this view to the Minister's notice. There would, I am convinced, be an utter disproportion between whatever advantage might be seen in linking an intention to tax wealth with the Prices and Incomes Bill and the financial consequences of disclosing such an intention.

p.s.

With reference to the final paragraph above, I have just received, with much relief, your letter of today informing me that there is now no question of any early decision or announcement about a tax on wealth. Thank you. "

A letter came the next day from Mr. Murray saying "you can take it that I fully accept the principle of prior consultation, and will continue to do what I can to ensure that principle and practice converge".

The second bone of contention was a proposal to extend price control to bank interest rates. The Minister's announcement of 16 October, referred to earlier, contained, under the rubric "Fees", the words "Professional fees, insurance and banking charges will be controlled". Mr. Seán Murray (Assistant Secretary, Department of Finance) had phoned me before this announcement to say that he had been "asked to let me know" that it contained a reference to control of banking charges.

It was not then clear whether this covered interest charges and I made the comment, repeated in a Central Bank letter of 27 October, that, if it did, the exercise of control of this kind would be appropriate to the Central Bank. There followed over the next few days an exchange of correspondence between Mr. C. H. Murray and myself in which I emphasised that it would be preferable if interest charges were not brought within the scope of the legislation but were left to be dealt with by the Central Bank, which could be relied upon to use its influence with the various financial institutions to prevent any unjustifiable increase in interest charges. This course, I said, would avoid any overt conflict between the powers and duties in regard to credit control which Section 6 of the Central Bank Act, 1942, placed on the Central Bank and the exercise of interest rate control by the Minister for Finance or his Officers. I argued that, had there been consultation with the Central Bank before the decision was taken, I would have asked Mr. Murray to bring to the Minister's notice the point that interest rates differed from other prices; in particular, they might have to be varied for credit policy or wider economic purposes and could not, therefore, be regarded merely as a factor affecting the general level of prices. "To be specific, the Central Bank might well favour a raising of the general level of interest rates - on deposits and advances - as a means of counteracting too sharp an exodus of funds . . ."

Finally, I said that, if the Minister's decisions were not open to reconsideration, the Central Bank would have to rest on Mr. Murray's assurance that it would be fully consulted before any interest rate controls were exercised. The Board of the Bank would not, I believed, accept that officials of the Bank could be appointed by the Minister as "authorised officers" to administer such controls.

In the event, the legislation, as already recorded, was withdrawn.

I shall leave there my account of Central Bank relations with the Government in 1970-71, though the final quarter of that financial year has not been covered. It seems better to open the chapter on 1971-72 with the stocktaking and preliminary policy formulation for 1971-72 to which all minds were turning with the dawn of the new calendar year.

V. ADVICE AND COMMENT, END 1970 - MID 1972

As 1970 moved to an end, the Department of Finance was exerting strong pressure on Departments to revise downwards their Estimates for 1971/72. I reminded Mr. C.H. Murray on 3 December, 1970, of the danger of their producing spurious reductions, below what their ongoing commitments would, in fact, require, citing our unhappy experience of Agriculture, Health and Social Welfare in particular, where, because rates of payment were fixed, actual expenditure must be met (through Supplementary Votes) whether the original estimates were valid or not. I also repeated my concern at the decision to allow Employer/Labour discussions the dominant role in determining wage and salary increases in 1971, urging that the Government should firmly decide not to sanction increases of more than 6%: "since the process of reducing cost-inflation will take a number of years to achieve success, we should be ready to withstand increasing pressure on the wages front until it is established for all to see that moderation pays in terms of a lower price rise and better economic conditions".

My letter also contained the following:

"I do not dispute the need for according, during periods of rapid price inflation, a high priority to the maintenance of minimum Social Welfare standards. There are other transfers, however, which do not merit such treatment. I would think it justifiable for the Government to resist suggestions that any further increases in farm incomes be effected by raising prices or subsidies. The improvements announced on 1 December should suffice for the time being; the farming community may reasonably be expected to wait for what the EEC will bring from 1973 onwards. As regards CIE I am sure you are worried that "sharp deteriorations" (i.e. millions of extra losses) can happen quite quickly without the management expecting them and without their being fully explicable even afterwards in terms of pay or other identifiable costs. CIE apparently does not regard itself as necessarily having to make do even with a statutorily - limited subsidy. Whatever new subsidy limit is determined, it should not be so liberal as to free the management from a strong and urgent sense of their responsibility to make the service pay within that limit".

The anxiety felt by the Central Bank regarding, in the words of the covering letter, "the particularly dangerous form of inflation indicated by the higher trend of incomes, prices and costs in Ireland than in the UK, the US and the more important Continental European countries" was reflected in its decision in January 1971, to address a formal memorandum to the Minister on "Prospects and Policies for 1971". This memorandum

was later substantially reproduced, under the same title, in the Spring Quarterly Bulletin (pp. 5-13). In its original form it read as follows:

Memorandum from Central Bank to Minister for Finance

Prospects and Policies for 1971

1 General

1. The Board of the Central Bank presents this memorandum to the Minister for Finance early in 1971 because of the responsibility laid on the Board by the Central Bank Act, 1942, in relation to safeguarding the integrity of the currency. In this respect, the Board considers 1971 to be a critical year and the policies determined by the Government, particularly regarding the Budget, to be more important than ever before. The imminence of the decisive stage concerning entry to the European Economic Community adds to the significance of the policy decisions to be taken this Spring.
2. To look back on developments in 1970 is most disagreeable. It is obvious that not only the integrity of the currency, but the viability of the economy, would be gravely threatened by continuance of a deterioration which has left Ireland with one of the highest inflation rates in the Western world, with the growth of national production cut to half its potential by excessive cost increases and prolonged disputes, with unemployment raised, the balance-of-payments deficit running into a third year far above the tolerable size, and with questions being raised in banking and business circles about the stability of the parity with sterling.
3. A series of confidence checkpoints has to be faced throughout 1971 and an unfortunate experience at any of these could precipitate a crisis. Apart from unforeseen risks, the series includes:
 - (i) the outcome of the massive 1 February conversion/new issue operation, involving over £65 million, and further conversions of £48 million in March and September;
 - (ii) the interpretation which may be placed in the Dáil and elsewhere on the intention behind the currency provisions of the Central Bank Bill;
 - (iii) the risk of the Employer/Labour Conference Agreement being sabotaged;

- (iv) the terms of the 1971/72 Budget;
 - (v) the state and prospects of the economy when the terms of accession to EEC are clarified and the public decision about entry has to be taken.
4. In particular, the Board wishes to stress that failure of the Budget to convey both at home and abroad a sense of sound direction of national economic affairs would have critical consequences. The Budget must help to moderate the excessive degree of price and cost inflation which is the greatest danger to the economy and the currency. Government corrective policies will need the backing of consistently sustained publicity. The experience of other countries (e.g. Britain) shows how important it is for a deficit country to sustain the confidence of outside investors as well as of its own citizens. Ireland is particularly vulnerable to a lapse of financial confidence because of the statutory obligation to convert Irish pounds into sterling, the absence of effective control over movements of funds between the State and the rest of the Sterling Area, and the dependence of activity and employment on a continuing large inflow of capital. An increase in this vulnerability is indicated by the progressive decline for some years past in the ratio of external reserves to such criteria as the amount of potentially mobile funds, expenditure on imports and the deficit in visible trade. The total of currency in circulation and of deposit and current accounts in banking institutions in Ireland (now about £1,250 million) is an incomplete measure of the amount of potentially mobile funds. Even by reference to this total, however, the reserves have fallen from a 35 per cent. ratio at end-1966 to 23 per cent. at present, while the ratio of reserves to expenditure on imports has fallen over the same period from 59 per cent. to 42 per cent. and, to the deficit in visible trade, from 2 to 1 to 1.3 to 1.
5. To safeguard the economy and the currency, the Board considers that priority should be accorded to the following major objectives:
- (a) reduction of the rate of increase in money incomes and prices;
 - (b) return to a higher but sustainable rate of economic growth; and
 - (c) reduction of the balance-of-payments deficit.

The implications of these are considered below.

11 Incomes and Prices

6. Because the greatest danger to the competitiveness of Irish goods and services and to the external value of the currency comes from the relatively high rate of price inflation in Ireland, the greatest need is for moderation of the rate of increase in (i) money incomes and (ii) public expenditure and borrowing. These, though interlinked, are best considered separately. Abatement of cost inflation also depends on improved productivity, whether this comes from industrial peace or is secured more directly.

7. Incomes.

- (i) The outlook for 1971 is now determined by the twelfth round (second-phase) commitments carried into 1971 and by the terms of the recent Employer-Labour Conference Agreement, assuming it is faithfully observed. The minimum rate of increase in non-agricultural money incomes in 1971 is, therefore, likely to be $11\frac{1}{2}$ per cent., and for money incomes generally about 10 per cent. - three times the likely rate of growth of national production. This is not far short of recent trends and it is only by assuming industrial peace and a consequent increase in output that some slowing down in the rate of increase in unit labour costs in Irish manufacturing industry can be projected. Even so, any significant improvement as compared with the British trend in 1971 is not likely. It will be recalled that the OECD recently described inflation in Britain as "probably the most acute faced by any major country".
- (ii) Ireland's post-1966 experience and immediate prospects are set against those of the U.K., U.S. and Germany in the graph in the Appendix. * This graph shows that unit costs in Ireland have been rising relatively fast since late-1968 and that a prolonged effort will be needed to bring them into line. No comfort can yet be drawn from the existence of income and price inflation elsewhere. In fact, the ELC Agreement can be regarded only as a welcome alternative to utter chaos; it does not set us on the road to improved competitiveness. The second phase of the agreement embodies serious prospects of a worsening of the situation, particularly if prices continue to rise at the current rate. The prospective gap between aggregate money incomes and output suggests a probable rise in the general level of prices in Ireland of 6 to 7 per cent. in 1971 (as compared with 8 per cent. in 1970) and this is higher than that expected in most OECD countries.

* Not reproduced here - see page 7 of Spring Bulletin 1971.

8. Government expenditure and borrowing

- (i) It is obvious that a great responsibility is thrown on fiscal and monetary policies to moderate the dangerous inflationary trend. Whether they will do so depends very largely on the rate of increase in public expenditure and the size of the Government's borrowing requirement. Monetary policy cannot be effective unless it is supported by appropriate fiscal policy and unless Government proposals for borrowing from the banks and abroad are substantially reduced and adequately allow for the productive borrowing needs of the private sector.
- (ii) The rate of increase in Government expenditure (current and capital combined) has over the past three years averaged 18 per cent. per annum as against an average rate of increase in real GNP of less than 4 per cent. and in nominal or money GNP of 11 per cent. When public expenditure increases at a rate exceeding not only that of production but also that of GNP in money terms it is a powerful source of inflationary pressure. The excess expenditure has to be financed not only by tax increases which raise the price level but also by heavy borrowing from the banks and abroad which enlarges the balance of payments deficit.
- (iii) If, as present indications lead one to fear, current Government expenditure in 1971/72 were to be some 13 or 14 per cent. over the expected 1970/71 level, this would substantially exceed the revenue available at existing tax rates and entail further tax increases in order to avoid a deficit on current account. Never, however, was it more advisable than in 1971 that there should be little or no increase in indirect taxation - indeed in any form of taxation - because of the inter-action on the ELC Agreement. A rise in indirect taxation, apart from directly raising prices, would be doubly inflationary since the second phase of the ELC Agreement includes an escalator clause relating the size of the new wage increase to any price increase in excess of 4 per cent. over the preceding year. A price increase of $3\frac{1}{2}$ per cent. in 1971 is inevitable as a carry-over from the rising scale of prices throughout 1970. It must be expected, therefore, that any further increase in indirect taxes in 1971 would add to the size of the incomes

increase in the second phase of the present round. An increase in direct taxes could apply only to personal incomes since it would be inconceivable to add further to the burden of company taxation. At this time an increase in personal income tax could make it difficult to hold the line on the incomes front since the PAYE system has made workers acutely conscious of the effect of changes in income tax on their disposable income.

- (iv) It is essential, therefore, that the Government set their faces, before it is too late, against current expenditure in 1971/72 being higher than revenue at existing tax rates. A mere balance in the current budget falls short of what the economic situation strictly requires, having regard particularly to the desirability of financing part of the high public capital programme from the proceeds of taxation because of the inadequate contribution made from the savings of the public. A firm stand is, therefore, needed against assuming extra commitments, unless this must be done to relieve real hardship. In any event, the overriding consideration should be the avoidance both of a deficit on current account and of increased taxation because it is only by reducing the rate of increase in expenditure that the budget will make any contribution to relieving inflationary pressure and restoring a confident economic outlook.
- (v) On the capital side, it is disquieting to learn (in confidence) that the residual borrowing requirement has already been pushed up to £73 million. A reduction is an urgent necessity if a better economic balance is to be achieved. The problems, financial as well as economic, associated with such a huge Government borrowing requirement do not appear to be fully appreciated. Quite apart from the broad economic implications, the Associated Banks can no longer be looked to for anything like the £50 million of fresh Exchequer finance which has come to be expected of them annually in recent years. Their total annual credit-creating capacity, for the public and private sectors combined, may not henceforth be as much as this: the bank dispute has accentuated the switch of deposits to rival institutions. Even if the Government were to look to all the banking institutions, Associated and non-Associated, a borrowing figure of the order of £50 million would still approach one half of the aggregate growth in

deposit and current accounts, an excessive proportion of loanable resources in relation to reasonable private sector requirements for productive purposes in a mixed economy.

(vi) Other considerations are also relevant. The non-Associated Banks, apart from subsidiaries and affiliates of the Associated Banks, include foreign banks of which the most important are those with their headquarters in North America. Obviously, these may be less amenable to Government influence. In any case, the Government might well consider it undesirable to become dependent on them for finance to any significant extent because of the limitation on freedom of policy which this might entail. This would apply particularly to any large-scale or continuing reliance on externally-derived funds of such banks. A sharp reversal of the inflow of resources to these banks could place serious strain on other parts of the Irish banking system and on the external reserves.

(vii) Foreign borrowing both by the Government and State bodies has, in any case, been proceeding at too high a rate in recent years and needs to be moderated not only because it is a means of financing an excessive level of total expenditure but also because of the exchange risks involved. It is a virtual certainty that the exchange value of the Deutschemerk and certain other European currencies will be much higher before the end of this decade.

Foreign currency (much of it DM) indebtedness on foot of borrowing by the Government and State bodies has risen by about £85 million since March, 1966.

(viii) The truth of the matter is that aggregate expenditure, so much of which is Government-initiated or stimulated, is far beyond national capacity - as is evident from the excessive scale of the deficit in external payments. How urgent and real are the problems created by this disproportion is shown by the uncertainty whether the Associated Banks could afford to provide £25 million at 31 December (reduced to £20 million for agreement's sake, itself dependent on Central Bank rediscounting) and by the imminence of massive additional requirements not only at 31 March and during 1971/72 but earlier, in the context of National Loan conversion and cash issues.

- (ix) It is most important that the Government should give these problems serious attention in deciding on the level of public spending in 1971/72. The 1971 budget affords, in all likelihood, the last opportunity of bringing the current inflationary crisis under control.

9. Credit.

The position as regards credit policy can be determined only when information becomes available as to the true post-dispute position of the Associated and non-Associated Banks. The import figures for the final quarter of 1970 suggest that credit expanded beyond the desired limits during the bank dispute. The prospect for 1971/72 is that if there is to be any improvement in the balance-of-payments situation there will have to be a strict limitation on credit expansion. This will be very severe for the private sector, with obvious economic and political consequences, unless Government borrowing is reduced substantially below the 1970/71 total.

111 Economic Growth

10. (i) Early return to a better economic balance is important for several reasons. Without a sounder relationship between total expenditure (public and private combined) and national output, excessive price inflation will continue, the external payments deficit will worsen, and confidence will be jeopardised, with serious implications for future development as well as for the currency. Closer co-ordination of the trends in money incomes, expenditure and national output is essential in order to correct excessive price inflation and achieve a more competitive trading position. This in turn is the necessary foundation for the higher growth rate which would enable corresponding advances to be made in real incomes and social welfare. A moderate trend in money incomes, against a background of industrial peace and higher external demand for Irish goods and services, would be accompanied by a faster rise in productivity and, therefore, a reduced rate of increase in unit costs and prices. This would be enhanced by any direct success in raising productivity e.g. by training to relieve shortages of particular skills and by agreements leading to more flexible use of manpower.

- (ii) A further reason for urgent restoration of a more realistic economic balance and competitive cost situation is that a critical phase in regard to EEC entry is likely to be reached in the Autumn of 1971. Unless by that time national output is rising at a satisfactory rate, income expectations and public expenditure are better adjusted to reality, and the external deficit is within manageable dimensions, the gravest doubt must be held about the disposition and the capacity of the community to accept the strains involved in accession to the EEC. Action to correct inflation and restore confidence cannot, therefore, be postponed until 1972. All the economic and other measures required to create a more favourable basis for the approach to EEC membership must be made effective in 1971.
- (iii) The growth rate in 1970 can scarcely have exceeded two per cent. This low growth rate has been partly due to large-scale industrial unrest. Hopefully an improvement, sufficient, perhaps, to restore the growth rate to 3 per cent., may be expected in this regard in 1971. Apart from the known difficulties of certain exporting industries, there is evidence that import-competing industries have been affected both by tariff cuts and by the excessive rate of cost inflation. A further tariff cut is due this year and this makes it all the more necessary to reduce the rate of cost increase. Another important factor underlying the low growth rate of 1970 was the dislocation of the tourist industry, occasioned principally by the troubles in Northern Ireland but also attributable to the discouraging effect of successive price increases of the order witnessed in 1969 and 1970.
- (iv) Private investment would be encouraged by the creation of a less inflationary environment, in which the rate of increase in costs and prices was being reduced and demand promised to rise in a steady and sustained fashion. This consideration reinforces the case for avoiding any increase in indirect taxation in 1971. The recent increase in corporate taxation is inimical to private investment not just because

of the disincentive effects of the reduction in after-tax profits but more importantly because it reduces the cash flow out of which companies finance investment. The firms hardest hit by this are those whose position is most precarious - the import-competing firms. If private investment is to be maintained it will need to rely more than normally on outside resources and this requires that a reasonable proportion of the available credit should be reserved for the private sector.

- (v) Improvement in the growth rate depends primarily on the success of efforts to safeguard and improve the competitiveness of Irish products and services. These efforts must be directed not only to moderation of the rate of increase in money incomes and the improvement of productivity but also towards reduction of the rate of increase in current Government expenditure, towards greater concentration of capital expenditure (public and private) on productive purposes, towards ensuring adequate finance and a confident environment for private investment, and towards creating a sustainable balance between total expenditure and resources, so that the external payments deficit will be kept within safe limits.

IV Balance of Payments

11. These considerations have particular relevance as the balance-of-payments deficit for two years in succession has been at an exceptionally high level, which allows no room for flexibility in policy and involves dangerous exposure to any adverse turn of events. If the deficit were at a more reasonable level faster progress could be made towards restoring a 4 per cent. growth rate. The deficit for 1970 may be only some £10 million less than the exceptionally high figure of £69 million for 1969. It might well have been as great as in 1969 were it not for the dampening effect on economic activity, and therefore on imports, of the prolonged cement and bank strikes. Recovery in the rate of growth in the economy must be export-led because a purely home-generated expansion would widen still further the dangerous gap between imports and exports. An export-led recovery depends on a more competitive position being established for Irish goods and services and, in particular, as the Board urges, an early and effective implementation of the financial policy measures outlined in this memorandum.

On behalf of the Board

T.K. WHITAKER

Governor

Just before I sent this memorandum to the Minister I had written a note to Mr. C.H. Murray suggesting that the Minister might think it appropriate and helpful to circulate the memorandum to his colleagues, adding:

"Because the Board did not consider it to be within its province, there are no specific suggestions in the memorandum about how to curb current Government expenditure. I may, however, tell you informally that views were expressed to the effect that, within the total set by the availability of revenue at existing tax rates, priority should be reserved for expenditure which helps to make us permanently more competitive and that the strictest limits should be set to increased subsidisation of transport and (in view of impending EEC benefits) agriculture. Economies through reorganisation should be the means of curbing the upward trend in public transport losses. In view of the general rise in income levels some services now available to persons in the higher income brackets could revert to being private responsibilities. A particularly dangerous area directly in the Government's sphere of influence is that of public service "grade claims". The grant of such claims, apart from adding to the burden of taxation, could be said to violate the spirit of the ELC Agreement and would add to the difficulty of sustaining it".

The Spring Bulletin noted that "some of the difficulties to be faced in 1971 have already been surmounted - for example the outcome of the massive 1 February conversion/new issue operation, involving about £65 million, and the further conversion of £23 million in March has been reassuring, given the uncertainties created by the bank dispute". But, as the Bulletin reminded us, other hurdles had still to be crossed.

Low growth and high inflation were inherited from 1970, for which the following dismal figures were recorded:

a rise of only 1½% in real GNP but of 8.2% in the consumer price index, of 16% in total expenditure, of 9% in total private expenditure, of 21% in bank lending, of 13% in non-agricultural employee incomes and of 12% in unit wage costs in industries.

The balance of payments deficit was again over £60 million and the increase in non-agricultural employment dwindled to 0.6%.

As the Budget situation began to unfold, I found myself writing to Mr. C.H. Murray on 19 March, 1971, expressing the fear that revenue buoyancy was being overestimated while, at the same time, insufficient provision was being made for current expenditure, none at all being made for the extra-statutory CIE deficit and for public service pension increases. It seemed to me that a deficit of £15 to £20 million was in prospect and I said "there is no possibility of financing such a deficit in a non-inflationary way. The current expenditure rise involved (over 13%) would again be inordinate. The essential need, therefore, is to compress total current expenditure so that the deficit is one which a tolerable rise in personal income tax would bridge". I had already said to Mr. Murray on Tuesday, 16 March that, if income tax had to be raised for individuals, a straightforward increase in the rate was preferable to the withdrawal, in whole or part, of the 1970 reduced rate concession (as Mr. Murray had indicated to be in mind). I warned in my letter of 19 March that, because of the implications for the National Wage Agreement, it would be most inadvisable to add in any significant way to the consumer price index through increases in indirect taxation and I suggested that a reduction in the "excessive corporate tax of 58%" would be desirable to encourage new investment in industry. Above all, "to restore a confident atmosphere favourable to economic growth it is necessary that the budget be regarded ^{as} an indication of sound management of the economy. This impression would not be conveyed if another large current deficit looked like emerging..... I am strongly against postponing any due payments, particularly for wages and salaries (this remark seems to have been prompted by a suggestion

that the opening deficit might thus be artificially reduced). I ended with the words "it is relevant that, at the margin, a current deficit is financed by foreign borrowing" and asked Mr. Murray to show the Minister my comments.

The Budget was introduced on 28 April, 1971, and aimed at a balance (which in fact was realised though at higher level than originally projected) between current expenditure and revenue. Capital expenditure, set originally at £193 million, was increased in the October Supplementary Budget to safeguard and expand employment and finally amounted to £214 million. In the current Budget, additional aid was given to agriculture and social welfare payments were increased, most of the cost being met by withdrawing the reduced income tax rate for the first £100 of taxable income, while at the same time raising the minimum earned income relief. The glass of spirits went up by 2p and the pint by 1p, part of the increase in both cases going to the distillers, the brewers and the trade. It was a budget of moderate change, intended to safeguard the National Pay Agreement and thus retard inflation. Investment was encouraged by the introduction of "free depreciation" for a two-year period and, as the year progressed, the public capital programme was increased, and company tax reliefs granted, in order to give a boost to economic activity and strengthen business confidence. There was in fact an increase of 3% in GNP in 1971 and some slackening of inflationary pressures both in terms of prices and the external deficit. Indeed, the sluggish growth of industrial production, the rise in unemployment caused by this and by the sharp downturn in emigration, and the low rate of increase in domestic consumption (2%) were, by the year's end, being adduced as reasons for a more expansionary budget in 1972.

This being the economic and political climate in the period approaching 1972, this chapter will take us right up to and beyond the Budget of that year. One of the expansionary devices of that Budget - the specific inauguration of deficits on current account - will merit special attention, as will another matter which came to a head in 1972, the autonomy of the Central Bank in relation to changes in bank interest rates.

On 21 October, 1971, anticipating the early adoption of expansionary policy measures, I wrote as follows to Mr. Murray:

"Reflecting on your description of current budgetary trends and prospective fiscal developments in our conversation yesterday, I should like to put on record what appear to me to be the more important elements in the conjunctural situation, in so far as it impringes on economic policy.

The occurrence of a 3 per cent. rate of growth which seems likely in 1971 is a satisfactory performance in view of all the difficulties of the present time, political as well as economic.

Concern about the sluggish rate of industrial investment is shared by all who wish to see greater progress in national development and employment but, amongst the factors responsible, there are some (including the NI troubles) which cannot be reached by fiscal or monetary measures. It is, therefore, a source of comfort that present output trends suggest that a growth rate in the region of 4 per cent. may not unreasonably be expected in 1972 without any significant relaxation of demand management policies.

This is particularly fortunate because the external payments situation is unsatisfactory and affords virtually no scope for manoeuvre. It reflects the continuance of a dangerously high rate of domestic cost and price inflation. In order to achieve a satisfactory rate of output growth in 1972 and the stabilisation (or possibly increase in) employment which a growth rate in the 4 per cent. region would provide we will have to accept again next year an outsize balance-of-payments deficit, probably in the region of £80 million. We cannot rely indefinitely on a net capital inflow to finance deficits of this magnitude. Such inflows have proved volatile in the past, and indeed, are capable of being reversed

from one year to another. A major reverse could be cumulative; and it would be particularly unfortunate in the sphere of foreign direct investment, which is now probably the major dynamic factor in export expansion and general economic growth.

I am not for these reasons opposed to doing what can safely and usefully be done to accelerate improvement in the trends of output and employment. Hence, my support for the recent reduction in bank interest rates and for the present proposal to reverse last year's increase in company taxation, assuming (as you have given me to understand) that this can be done without opening up a large budgetary deficit on current account.

I remain convinced, however, that nothing should be done which would endanger the efforts begun last year to slow down our excessive rate of cost inflation. These efforts have as yet had only a marginal impact on income and price trends and they need to be reinforced by ensuring that a more moderate national wage and salary agreement will replace the current one. In this context, I must say I am apprehensive of the effects of the conceding in full of the 10 per cent. Civil Service grade awards. I think that a Government initiative to have them modified would have registered more strongly the vital importance for Ireland's economic future of a lower all-round ratio of income increases to real national output.

While cost inflation is the chief enemy at present, we cannot afford to forget that demand inflation, fed by very high rates of increase in public expenditure and borrowing, is a powerful inflationary force which has been moderated only recently and (as you know) with great difficulty. I, therefore, urge great selectivity in the purposes for which additional expenditure is conceded and great caution in keeping the rate of increase in total expenditure within manageable bounds. It would be most unwise to let the annual increase in public expenditure, capital or current, rise again to anywhere near the inordinate percentages of recent years. Apart from the bad effects this would have in creating a domestic climate favouring incomes expansion and in enlarging the external deficit, a return to what would be regarded as inflationary finance, involving large deficits in the current budget as well as heavy recourse to borrowing from banks and abroad, would negate any good effects on business confidence expected to result from a reduction in profits taxation. A growth rate of public expenditure which exceeds that of GNP in money terms would suggest, *prima facie*, that inflation was not being restrained by public sector policy. I understand that if the price rise for 1972

is to be reduced to 6-7 per cent. in the context of a real growth in GNP of 4 per cent. (nominal 11 per cent), the growth of public expenditure as a whole need not (and, therefore, should not) be substantially greater than was envisaged in the 1971 budget. Within this framework, I favour a stimulus through reduced taxation for private sector investment and more capital help for direct foreign investment.

The Economic Commentaries of the ESRI for the Autumn and Winter of 1971 took a rather bleak view of the growth prospects for 1972 unless countervailing action was taken. The economic repercussions of the Northern Ireland situation were bound to be serious. At the same time, the Commentaries emphasised the constraint imposed by the external deficit and the need for moderation in money pay claims. If pay negotiations were satisfactory less weight could be attached to the balance of payments constraint on the basis that prospective EEC entry and minerals development would tend to ease that difficulty.

My note of an interview with the Minister for Finance (Mr. Colley) on Friday 14 January 1972, reads as follows:

"I sought this interview with the Minister because of the imminence of a debate in the Dail on the unemployment problem and the risk that measures might be announced by way of increased Government expenditure without trying in advance to ensure that restraint on income increases would make these measures both safe and effective. The Secretary of the Department of Finance, Mr. C.H. Murray, was present at the interview.

I recalled that, this time last year, the Board of the Central Bank had sent in a formal memorandum to the Minister on prospects and policies for 1971. It was not intended to do this, for the present at any rate, in relation to 1972. The views of the Bank would be appearing in the Quarterly Bulletin due for publication

towards the end of January. I would like, however, to emphasise some considerations which I hoped the Minister would keep in mind.

First, as a sense of crisis and even "national emergency" was being created by political and press propaganda it was better to turn this to national economic advantage rather than appear to run before it. Measures causing further expansion of Government expenditure should not, therefore, be announced next week in advance of discussions with employers and unions designed to get a quid pro quo, namely, some prolongation of the duration of the second phase of the National Wage Agreement and a less inflationary Agreement to follow. The scope for manoeuvre regarding Government expenditure was very slight. The balance-of-payments deficit was still at a peak and the rise in public expenditure, projected at under 10 per cent. for 1971/72 in the last Budget had already climbed to over 14 per cent. At this rate of increase, and a fortiori if the rate were further stepped up, public expenditure was a powerful expansionary force. It was a fundamental requirement, if unemployment was to be reduced and new employment stimulated, that the rate of cost increase in Ireland be substantially reduced. Central Bank calculations showed that no more than an 8 per cent. rise in incomes in 1972 could be accommodated if the rate of price increase were to be brought down to 5 per cent. from the exceptionally high current level, by international standards, of between 8 and 9 per cent. The reason for specifying a reduction to 5 per cent. as an interim and urgent requirement was that the prospect, as noted by OECD, for many of the important Western countries with which we deal is that the rate of price increase in 1972 will be lowered to $4\frac{1}{2}$ to 5 per cent. We had for too long been suffering from relatively high inflation. The result was that, even though there had been inflation in the UK, United States, and various European countries, we had been keeping well in front of the field. The absolute level of wages and salaries in Ireland was now very close to that in Britain, although the productivity difference was still marked. The prospect for 1972 was that there would be a strong recovery in production in both the UK and the US. This would provide a big productivity offset to income increases and thus lower the rate of price increase in these countries. We could not afford to be out of line with conditions in the major markets for our products and services, so we had to get down the rate of wage and price inflation here unless we wanted to see more and more firms going out of business, more redundancies, more unemployment. There was an opportunity now for a negotiated deal in which some measures of expansion would be swapped for a firm commitment to incomes restraint and it would be unfortunate if this were let slip.

To this the Minister replied that it would be necessary to take a positive line in the debate on the economic situation next week;

this was of vital importance because of the imminence of the referendum on accession to the EEC. I asked him when this referendum was likely to take place and, on his saying "probably April" I suggested strongly that it was worth spending ten days or a fortnight now in discussions with unions and employers and coming up with an arrangement which would confirm that good management of the economy prevailed and that the prospects even under EEC conditions would be good. The Minister seemed to be worried whether trade unionists might not consider that a squeeze was being put on them and react by voting against the EEC. I thought that anything that was given too readily was virtually ignored e.g. the extra £20 million of Government expenditure last October and the increase in the price of milk, and that a more favourable impact would be made on business investment and on public confidence generally by negotiations which showed Government concern to protect the economy and ensure satisfactory growth. The referendum would be over in April but the problems of growth and employment would be with us for the rest of 1972 and thereafter.

The second point I emphasised was that, in relation to any increase in public expenditure, consideration should be given to the undesirability of adding to costs by way of indirect taxation increases and to the desirability of choosing productive capital items, especially those where overtaking of arrears or acceleration was desirable in the light of EEC membership and the tempo could be relaxed in the future. Telephone development came to mind in this connection but there might be a case for some increase under other headings such as housing and main national roads.

Mr. Murray supported my plea for having talks with employers and unions before any definite commitments on expenditure were made by the Government. I suggested that it would suffice, in the debate next week, to analyse the unemployment situation in a cool but not callous way, indicating that the Government was prepared to take action provided conditions were established which would make it effective. The prospects of improvement in the external economic environment could also be discussed.

The Minister promised to consider what I had said."

The foregoing interview took place before the events in Derry on January 30, 1972 ("Bloody Sunday"), which were followed within a few days by the burning of the British Embassy in Merrion Square, Dublin. At a stroke the economic portents were made bleaker still. I wrote to Mr. Murray on 9 February asking whether it was realistic to proceed on the assumption that developments in the economy would follow a reasonably normal course in 1972. "It would seem already that we face a big drop in tourist

earnings. The outlook for merchandise exports and for employment could also be less favourable than we once thought". I suggested that we should "envisage alternative courses of action according to the evolution of events" and asked whether it would be "worthwhile considering the possibility of not having a budget at the usual time but just carrying on with the present revenue and the minimum increase in current expenditure until the early Autumn". Such a deferment would postpone the less pressing expectations of budgetary "handouts", would leave more political time and energy for the EEC referendum campaign, would give more flexibility during the coming critical months, and could be associated with a move as from 1973 to the calendar year as the common EEC fiscal accounting period.

Later that month (18 February), when I saw the Minister and Mr. Murray about the budgetary proposals, "a long discussion took place on the post-Derry economic prospects and their implications for general as well as budgetary policy. It was agreed that particular efforts should be made to support tourism (but with the emphasis on encouraging the tourist, rather than subsidising the hotel). The advantages and disadvantages of postponing the Budget until the Autumn were discussed. On balance the Minister thought it better to stick to the traditional procedure".

The principal matter discussed, however, was the proposal to depart openly from the tradition of attempting to balance the current budget. On this my note reads:

"On the question of the deliberate and open incurring of a deficit on the current account of the budget, I argued with Mr. Murray, and later with the Minister, that this was not necessary as an economic stimulus and that it would be a dangerous innovation. It would remove one of the few remaining disciplines. It would disturb business confidence, if it were large, without impressing the trade unions or others as much as would a more direct stimulus to employment. On Keynesian principles (as Mr. Murray agreed), it was not the current account deficit that mattered but the deficit in the Budget as a whole, capital as well as current, and we were properly relying on the capital budget to provide the expansionary stimulus. We would get more direct value in terms of jobs and lasting assets in this way, while (contrary to textbook reservations) capital expenditure was in fact more flexible in our circumstances than current expenditure, which consisted so largely of irreducible items like pay, pensions and social welfare. The only way to control current expenditure was by being extremely careful about committing oneself to new expenditure: a case in point was the unreserved acceptance in the Autumn of the "grade claim award"

in the Civil Service. Once a very large deficit had been allowed to appear (and the Minister contended that even a £10 million deficit would look paltry as it had happened accidentally several times in the past), I said that the Government would find it extremely hard on political grounds ever to close the gap again, even when this course was dictated by sound economic principles. I argued, therefore, for taxing at least to meet new social benefits (resorting to some of the "old reliables") and for not contemplating, covertly or overtly, a much bigger current deficit than £10 million. A few exceptional items might be identified as helping to justify at the present time a higher-than-usual deficit but any formal transfer of new items to capital account would lack credibility".

These arguments proved unavailing. The 1972 Budget provided for a current account deficit of £27.8 million and the taking into the Exchequer from the Central Bank for current purposes of £7 million of accumulated surplus income - additional spending power which, with the increase of £30 million in the public capital programme, was expected to raise the national growth rate by about $1\frac{3}{4}$ per cent. The Minister's presentation was as follows:

"When introducing the supplementary Budget in October 1970, I indicated that, while over most of the 1960's, a deliberate policy of deficit budgeting would have been contrary to the requirements of our general economic situation, the Government would in future aim at a deficit when economic activity was depressed and at a surplus in conditions of inflation. I have to consider whether on this test I should seek to balance the budget this year or should aim at either a surplus or a deficit. Present and prospective economic circumstances provide no clear-cut, unambiguous answer to this question. The rate of price increase is still high and the balance of payments position is weak. Nowhere is inflation more marked than in labour costs. In 1971 the rate of increase in unit labour costs in this country was second highest amongst European countries, and there is little indication that we are losing this unenviable place in the league tables. Whatever our hopes, there is no certainty that the new National Pay Agreement will diminish the pace of cost inflation. These factors would suggest that the budget should be directed at containing inflationary pressures or, at least, not adding to them.

On the other hand, the economy is, for the third year in succession, running at well below capacity. Unemployment is high. We lack the economic buoyancy required to tackle quickly and effectively the adaptation which membership of the EEC will demand. If priority were given to these factors, budgetary policy

should be primarily directed at improving the growth performance of the economy.

Faced with these competing requirements, the Government have opted for growth rather than stability. The level of Government expenditure this year will, therefore, be determined by reference to our economic requirements and will not be cut back to the estimated yield of revenue. There will not be any increases in taxation, and the resultant deficit in the current budget will be financed mainly by borrowing".

The Minister's presentation does not seem to recognise the point I had made in my interview with him on 18 February, namely, that it was the total budgetary deficit (capital and current combined) that was relevant to a Keynesian expansionary programme. Nor does it recognise that in a country still lacking many infrastructural facilities, it would have been much better to borrow only for additional capital expenditure. I can claim no great prophetic insight but the record of what happened, once this door was opened, affords striking confirmation of my worst fears:

Actual Deficit on Current Budget

	£m
1972/73	5
1973/74	11
1974 (nine months)	92
1975	259
1976	201
1977	<u>209</u>
Total	<u>£777 million *</u>

This £777 million of borrowings for current purposes since the 1972 Budget represented nearly one-third of total Exchequer borrowings (£2435m.) for all purposes.

I regard the opening up of current deficits as a most regrettable decision. I cannot but think that it was taken without full advertence to its longer term economic and political implications. I have often wondered whether the advice the Minister received from his Department was sufficiently clear and cogent or whether he himself preferred, on short-term grounds, to follow a course which enabled him to be generous with income tax reliefs and social welfare benefits in the lead-up to national pay negotiations and the EEC referendum. That the Minister himself had doubts is

* A further £400 million was added in 1978!

evident from the vivid acknowledgment in his Budget speech: "I may be fuelling the fire of inflation rather than the engine of growth". Whatever the explanation, the consequences were unfortunate; within a year, much larger deficits, involving heavy foreign borrowing just to finance current outgoings, were being undertaken with an air of theoretical respectability but with little or no regard to the desirability of using foreign borrowings for purposes which would raise national productivity or at least leave behind useful additions to national capital in the form of roads, educational buildings, hospitals or other social assets. Much of the criticism by the Central Bank of public finance in the years since 1972 was along these lines, reinforced by the argument that with more income restraint, more jobs could have been sustained and created with less Government borrowing, whether on capital or current account. The Central Bank did not, of course, gainsay the need for fiscal expansionary measures to support economic activity. The criticism referred to method and scale. It is ironic that as far back as 1952, the point had been made (at my instance, I might add) by the then Minister for Finance, Mr. Seán MacEntee, by way of a special note to Voted Capital Services that it was not always and necessarily appropriate to finance even capital expenditure by borrowing; the note correctly stated that, from the economic standpoint, it was the total of public expenditure, and how it was financed, that mattered and that it was the method of financing the total which should be adjusted to national economic requirements.

To return to the 1972 Budget, the Central Bank's Spring Bulletin had admitted that economic activity was below capacity but urged that it was more urgent than ever, because of the less attractive growth prospects, to negotiate a new and substantially less inflationary National Pay Agreement. "In the absence of such an agreement, measures to stimulate the economy might not only fail to achieve their objectives but could also have adverse effects on the price level". The Bulletin showed that industrial unit wage costs, adjusted for exchange rate variations, had been going up faster in Ireland than in the U.K. during 1970 and 1971.

On 11 April, 1972, I had written the following letter to Mr. Murray as a final piece of budgetary advice:

"I sent a manuscript note in Irish to the Minister on Sunday before leaving for Basle, in which I commented particularly on the excessive size of the prospective budgetary deficit (current and capital combined) and on the inadvisability of costly personal reliefs in income tax while the inflationary surge in incomes continues.

In this note I summarise and explain my views on the budgetary proposals.

I accept that this is a year for giving an expansionary push to the economy in the hope of raising the growth rate and sustaining employment. But we have to keep in mind that (1) the sluggishness of the economy is not basically due to the falling off in tourist income arising from political causes but rather to our relatively severe labour cost inflation and (2) the balance of payments position is weak.

My main fear is that if strong expansion of demand takes place in the absence of restraint of income increases, we shall end up in a worse position - with an acceleration of the wage-price spiral, greater employment difficulties and an ebbing away of confidence. An atmosphere of budgetary expansion and temporary buoyancy of demand is not one in which, left to themselves, trade unions will exercise restraint or employers be concerned to resist excessive wage claims. But unless expansion operates on moderate incomes it will do harm rather than good as far as exports and jobs are concerned.

I would consider it most important, therefore, that a serious effort should be made, before an expansionary budget involving no tax increases is announced, to establish the quid pro quo of a commitment by unions and employers organisations to moderate rates of pay increase. If such an understanding cannot be reached, the budget deficit should be cut down substantially on the basis that further expansion of demand must, for sound economic reasons, be contingent on the completion of a moderate national pay agreement. Otherwise, low growth and high unemployment will become a chronic condition.

On the details of the proposals, I consider the surplus-deficit swing from 1971/72 to 1972/73 on the current budget much too large and too sudden - it is of the order of £40 million, since the once-for-all arrears of surplus income from the Central Bank will reduce it only arithmetically, not in its expansionary effect. There is also the £34 million increase in capital expenditure to be remembered. On both sides of the account, current and capital, there is a dangerous degree of dependence, looking to the future, on fortuitous, non-recurring sources of finance, including drawings from the Central Bank on a scale which may provide an excessive liquidity base for bank lending. Our taxation base, on the other hand, is as yet insufficiently wide and politically flexible to justify any unnecessary erosion in the form of expensive new reliefs.

I would consider it better to plan for a smaller boost to GNP by means of expansionary budgetary measures (keeping the current deficit below £20m) and to seek a greater part of the desired stimulus to employment and growth by improving competitiveness through an effective incomes policy. We are dangerously ahead of the field in regard to the rate of increase in unit costs.

I would be obliged if you would bring this letter to the Minister's notice."

By way of postscript, I might add that, while the outcome of the EEC referendum was strongly positive, the proposed National Pay Agreement which (in the Central Bank's terms) " would have done little to lower the rate of price inflation", was rejected by the majority of trade unions and was replaced by a more inflationary one, which on Charles McCarthy's illustration*, would give, over a period of seventeen or eighteen months, a 21% increase (following the 1970 Agreement's 17.9%) to a man earning £20 a week on 31 December 1970.

During this period of apprehension about the new Pay Agreement the Central Bank (in its Summer 1972 Report) tried again to present in a simple, forceful way the reasons why a moderate pay increase should be accepted. Having pointed to the danger to our competitiveness of the relatively fast rise in wage costs per unit of output and to the prospects of reduced inflation rates in Britain and other major countries, the Bank said that we in Ireland could ignore these trends only at our peril. "If we cannot climb down quickly from our present rate of price increase, we shall find it difficult to hold export markets, to sustain tourism and to sell Irish products against imported alternatives". Unless the disproportionate rise in current Government expenditure were corrected, economic conditions (requiring at some future time a balanced or surplus budget) would probably necessitate a rise in indirect tax rates with an attendant increase in prices. The focus, however, was on wage and salary increases as a source of inflationary developments because it was these which were leading the growth in money incomes generally. It was the growth rate of the economy that determined

* A Review of the Objectives of the National Pay Agreements 1970-1977" Administration, Spring 1977 - page 125

how much of a real increase there could be in the community's income. A lower rate of increase in money incomes would give as big a real improvement because prices would not rise so fast and it would safeguard existing jobs and help create new ones by stimulating sales of our products and services. The tendency to seek "compensation" by way of new wage and salary increases for a previous rise in prices was understandable but it was, on national economic grounds, most regrettable. It ignored the urgent need to wind down the inflationary spiral and the advantages for the worker and his family and for the economy generally of bringing down the rate of price increase, particularly as this required no sacrifice of real income. "The "compensation" case also takes insufficient account of the fact that wages and salaries have, in fact, been rising faster than the cost of living - by an annual $14\frac{1}{2}$ per cent. over the three years 1969 to 1971, as compared with an average annual rise of about $8\frac{1}{2}$ per cent. in consumer prices. There has been, in consequence, a substantial redistribution of income in favour of wage and salary earners. Unfortunately, this has not taken place in the context of an adequate expansion of the economy as a whole. Because of lower investment (partly due to a decline in profits) and impairment of competitiveness by cost increases, employment and real growth have been held below their potential. A large balance of payments deficit has also been incurred."

Looking towards our imminent membership of the EEC, the Report stressed the big and sustained increase in Ireland's growth rate (over $7\frac{1}{2}$ % per annum as compared with an average of 4% in the 1960's) which would be needed to secure, for a rising population, a reasonable advance towards the standards already enjoyed in the Community. "We cannot hope to succeed unless our production costs are held sufficiently below Community levels to give us a marked competitive advantage. We shall also need, as assured in the Protocol to the Treaty of Accession, the support of the Community, through its policies and financial arrangements, in correcting the present imbalance both between ourselves and the rest of the Community and between the various parts of Ireland".

To drive home what was said in the Report I wrote to the Minister for Finance on 29 June 1972:

"I feel I should supplement in blunter language the observations in the extract from our draft Report which I sent you yesterday.

I am afraid we may be on the way to a differential devaluation of the Irish pound against sterling - itself the weakest of EEC currencies.

No one need try to make a virtue of such a devaluation: it would register our failure to check unreasonable ambitions and make the most of our resources. The higher the rate of exchange at which we can secure capacity growth ^{and} ~~of~~ progress towards full employment, the greater is the real benefit to the community. The forces which first pushed us down from the traditional parity would not become quiescent at the lower level and would generate much social conflict. Moreover, one of the few economic disciplines we have left would cease to operate. This would also be a most inopportune time to create a new division between North and South.

I need hardly urge, therefore, the importance of bringing home to all concerned, especially the trade unions, the transcendent need for a reasonable and disciplined approach to wage and salary increases. If the ICTU cannot ensure that increases will stay within the bounds of the Agreement originally proposed - and even these were dangerously high - statutory intervention, as in the Autumn of 1970, to prevent higher increases seems inescapable. Other expedients, such as excluding any excess percentage from price adjustments, and rigidly keeping State expenditure on building etc. within the financial allocation in the Budget, though helpful, do not go to the root of the problem; nor are they comprehensive".

VI. REGULATION OF INTEREST RATES

The Central Bank first began early in 1955 to intervene to modify the previous automaticity of changes in interest rates in Ireland in line with changes in Britain (see Appendix 1 and Dr. Moynihan's book, pages 420 et seq). In subsequent years an interest rate policy of modified parallelism was established. Obviously, with free movement of funds, any marked and prolonged differentiation of interest rates between the two countries would have been impracticable. It was found, however, that inertia and inattention, if one might so summarise the operative factors, did create to some degree a separate market for funds in Ireland and the practice became stabilised of adjusting interest rates upwards rather less than the extent of British adjustments, though downward moves were usually to the same level, if not lower. Indeed, for some years past the aim has been to keep the prime rate here one percentage point below the corresponding British rate. Delay in downward adjustment naturally caused less risk of outward movement of funds than its counterpart, but some delay in both cases, and a certain smoothening of fluctuations, came to be accepted as an appropriate Irish reaction, given that the principle was recognised here of moving in time in the same direction as rates moved across-Channel. The Central Bank and the Department of Finance tried to ensure that the individual moves brought no significant long-term profit (or loss) to the commercial banks. It was only in the 1970's that this profit or loss effect came to be viewed, not in relation to the status quo at the time of each change, but in relation to the overall profitability standards which the Central Bank judged to be appropriate targets for the Associated Banks.

In 1955 the Minister for Finance of the time had no difficulty in accepting that the scope for manoeuvre in the matter of interest rates was limited and that the trend set by changes in British rates had to be followed, even if at a slight remove. With the floating of sterling at the end of June 1972 interest rate changes became more frequent as a means of countering movements of short-term funds which could jeopardise the exchange rate. When the British interest rates went up steeply at the end of July 1972 change here was delayed more than was usual under strong pressure from the Minister for Finance, who wished to avoid any increase at all. The differentials were already $1\frac{1}{2}$ to 2% (as against a tolerable or traditional 1%) when my aid was sought to persuade the Minister to relent. The Associated Banks were apprehensive about an imminent outflow of resources and also a transfer of deposits to the non-associated banks, who had already adjusted their rates upwards.

I had gone to Reykjavik to give a talk on Ireland's Economic Development and was fishing with the Governor of the Central Bank of Iceland in a remote corner of the North West of Iceland when a Land Rover arrived carrying a telex to the foregoing effect which the General Manager of the Central Bank, Bernard Breen, had asked the Central

Bank of Iceland to deliver. I abandoned fishing temporarily to cable back:-

"Agree present and prospective interest differentials too large to be maintained with safety to Irish economy. Press Department of Finance to accept 1 per cent all round".

Mr. Breen took the matter up with Mr. Murray, informing him that, apart from requests for increased accommodation which they had refused to sanction, there had been an adverse impact of at least £7 million on the resources of the two major Associated Bank groups in recent days. He also assured Mr. Murray that the proposed 1% upward revision would be without prejudice to the forthcoming enquiry into the level of the Banks' profitability; the effect, in any case, would be to reduce their profitability.

The Minister, however, was still adopting a Canute-like stance. Mr. Murray reported that the Minister was "reluctant to see any change in the present position unless and until evidence becomes available of a trend towards a substantial fall in the external reserves".

On my return from Iceland I wrote as follows to Mr. Murray on 8 August, 1972:

"I have read the exchange of correspondence between the Irish Banks' Standing Committee, the Central Bank and the Department of Finance concerning the proposed across-the-board increase of 1 per cent. in Associated Bank interest rates.

I consider that the proposed increase is consistent with the current and prospective needs of the economy. In the opening months of the credit-policy year there has been a very substantial growth in bank credit. Data for all banks indicate that, after allowing for exceptional items, there was an increase in total lending of over £50 million between mid-April and end-June 1972. This increase, which is contributing greatly to the expansion of economic activity, may be compared with the anticipated growth in total bank lending for the year to April next of £160 million. If this trend were to continue and, at the same time, the inflationary Pay Agreement were to affect seriously our external position, consideration would have to be given to the introduction of measures designed to moderate the growth of bank lending.

Over the same April-June period, deposits with the non-Associated banks grew by some £20 million - as compared with less than £15 million during the entire year to April 1972 - and the latest divergence of their interest rates from those of the Associated Banks (which occurred without reference to the Central Bank) must lead to a further move of deposits to them. There is evidence that this is

taking place at present. On 30 June a differential was established between clearing bank rates in Britain - to which non-Associated bank interest rates are closely linked - and those of the Associated Banks, and this margin was expanded on 21 July. In the case of deposit rates, a differential of 1 per cent. arose at end-June, and a further increase of $1\frac{1}{4}$ per cent. on 21 July increased the differential, as against the Associated Banks, to $2\frac{1}{4}$ per cent. The differential in minimum lending rates, which was $\frac{1}{2}$ per cent. on 30 June, rose to $1\frac{1}{2}$ per cent. on 21 July. Over the earlier part of the period for which these differentials have obtained - that is, from 30 June to 18 July - deposits with North American Banks and Merchant Banks rose by £6.1 million, and this was accompanied by a reduction of £2.3 million in the current and deposit account resources of the Associated Banks.

This must be of detriment to the economy, since, as is reflected in the substantial net outflows of capital through them since April last, and, in particular, in the net outflow of £7.7 million through the North American and Merchant Groups between end-June and 18 July, the non-Associated Banks are not equipped to satisfy the borrowing needs of all sectors of the community. It is also of significance in this connection that there was a sharp reduction in the primary liquidity ratio of the Associated Banks between mid-April and end-June, arising from the growth in their lending and from a substantial decline in their liquid holdings. The subsequent loss of resources both to the non-Associated banks and abroad will further impinge on their liquidity and restrict their ability to lend within the economy.

The official external reserves declined by £20 million between April and June 1972, as compared with a reduction of only £0.4 million during the corresponding period of 1971, and there has been a further fall of £6 million during the month of July. However, while there was an increase of £28 million in the external reserves in the month of August 1971, during the first week of the current month the increase has amounted to only £0.9 million. The effect on the reserves of the wide interest-rate differential now obtaining is difficult to isolate, since the other influences operating on the reserves cannot be measured over so short a period. It would, however, be unwise, particularly in view of the current uncertain external environment, to permit a continuance of this factor, which can only act to the detriment of the external reserves.

In the light of all these circumstances, the Central Bank considers it appropriate to agree to an across-the-board increase of 1 per cent. in the interest rates of the Associated Banks. There is really no point in trying to stand against the international trend in interest rates, particularly against the trend in a country with which we have a close approach to monetary union. We can only damage our own interests by doing so."

Mr. Murray replied the very same day as follows:-

"Your letter of today's date regarding the question of Associated Bank interest rates arrived when I happened to be in the office in between a spell of annual leave. I showed it at once to the Minister who gave careful consideration to your arguments. While he fully accepts that a continuance of the differential in interest rates could cause a problem, he remains unconvinced that the problem is as yet serious enough to warrant action. He is strongly of the opinion that we should keep our options open at this stage and let matters rest at least for a further week or two until we see how things develop.

The Minister's thinking is strongly influenced by the need to reflate the economy and by the present high level of external reserves, despite the decrease since April last. He accepts, of course, that the reserves benefited from an exceptional capital inflow last year but considers that, at their present level, they give us some breathing space.

I put it to the Minister that you might wish to have an opportunity of discussing the matter with him and he asked me to let you know that he would be quite happy to arrange a meeting should you so wish. Though I will be out of the office for the next few days, I will not be out of Dublin and will be available to attend the Minister should you wish to see him.

The Minister asked me to mention two related points to you -

- (i) Is it possible to amend the credit control advice to the non-Associated Banks by providing that for the rest of the credit year there should be no net outflow of funds through such banks (whatever about a net inflow sufficient to offset the net outflow that has already taken place to date)?
- (ii) Alternatively, or concurrently, should not the present informal arrangements under which changes in Associated Bank rates are informally controlled not be extended to non-Associated Banks as well - even if both arrangements had to be put on a statutory basis?

The Minister accepts that even if the second point were practicable it would take some time to implement and might not, therefore, be relevant in connexion with the present problem."

To this I rejoined on 17 August:

"I got your letter of 8 August about bank interest rates on Tuesday, 15 August, when I came back to Dublin for a few days.

While I understand the Minister's attitude, in deference to which a further deferment of action by the Bank has been arranged, I considered it would be helpful if I could have a discussion with him. Unfortunately, I hear that he is now away himself and a meeting this week, before I return to the West, is impossible.

Basically, the choice we have is between (1) allowing free movement of funds between here and the U.K. to continue (with the corollary that, apart from minor and temporary deviations, there must be parallel movement of interest rates) and (2) introducing controls, which to be even partly effective would need to be comprehensive and closely policed. My judgment, supported I believe by experience, is that choice (1) is likely to be much more to our advantage than choice (2). With (1) we can expect to continue to be a capital-importing country without having to borrow directly abroad on an awkward scale. Under (2) I am afraid no one would want to lend to Irish banks or other residents because of the risk of not getting his money back when he needed it, not to mention that of being forced to accept a relatively low interest rate as well. It is possible to urge the non-Associated Banks not to incur external liabilities beyond a certain limit but it would not be feasible, without putting them out of business, to forbid them to repay external liabilities if and when repayment is demanded.

Because we have so far followed choice (1), the question of control of interest rates, whether of Associated or non-Associated Banks, has not been a live issue. It would be an embarrassing pretence for the Central Bank or any other authority to have a virtually inexercisable power. All any authority could do, granted mobility of funds between South and North and across-Channel, would be to try (as we have been doing with some success for years) to moderate the impact here of upward or downward fluctuations in British rates, while at the same time following their general trend. In effect, when our deposit rates happen for a time to be lower than in the U.K., we are relying on the stabilising effect of public inattention or inertia. This is becoming less and less dependable according as more and more people, even those with modest funds, are becoming aware of the existence - and importance to them - of interest differentials. During these weeks we may be enjoying the ephemeral protection afforded by absence of decision-makers on holidays!

The Minister does, I think, accept that, without controls (and I would be strongly opposed to these) a marked differential between Irish and U.K. interest rates cannot be sustained. Whatever stimulus lower rates here may give to economic expansion cannot, therefore, at best be other than short-lived. Only a moderate adjustment is contemplated and I am certain that this would not operate to reduce credit expansion below the level consistent with the Government's economic objectives.

I consider that, in the conditions obtaining here, autonomous interest rate changes are not in fact available as an instrument of national economic adjustment. Indeed, their role in this respect is being diminished everywhere by the international

pressure for co-operation in controlling movements of short-term funds. Interest rates are not, therefore, a policy issue in Ireland. The "moderating" I mentioned earlier should be regarded as one function (and a rather minor one) amongst those exercised by the Central Bank in its duty of seeing that credit conditions are conducive to the general welfare. The amount of credit, and the purposes for which it is made available, are much more important than changes of 1 per cent. or so in interest rates. The running down of banking (and national) liquidity cannot, so far as I can see, bring any adequate offsetting benefit. So I think the present differential has been held for long enough and I doubt if the Minister would further oppose this view, since your letter of 8 August spoke of letting matters rest just for a further week or two and the considerations I have outlined above are not without force.

The Central Bank has accepted that its detailed administration of credit policy for 1972/73 should be directed towards achieving the economic objectives set by the Government. To use a simple metaphor, the monetary car is being driven towards an agreed destination. It seems appropriate that the driver should have discretion as to when to change the gears having regard to the ups and downs of the road, and as to what level of petrol to keep in the tank. This point is the same as that made in paragraph 6 of the note on "Responsibility for Credit Policy" (which I sent you personally on 7 January 1970) and in the course of my interview with the Minister and yourself on 14 January 1970."

The interview with the Minister for Finance took place on 30 August and my account of it dated 15 September reads:

"The interview took place, by arrangement, at 12.15 p.m. The Secretary of the Department, Mr. C.H. Murray, was also present.

I asked the Minister not to request any further deferment of the proposed rise in bank deposit and lending rates here. The holding of the Irish rates at the levels fixed in April, despite the upward moves in June and July in corresponding rates in Britain, had produced a bigger differential than had ever been maintained in the past. For large deposits the Irish rate was now $1\frac{1}{4}$ to $1\frac{1}{2}$ per cent. below the U.K. rate, while for deposits under £25,000 the differential was as much as $2\frac{1}{4}$ per cent. It had always been recognised that, because of the freedom of Irish companies and individuals to place their money to the best advantage in these islands, we had to follow the general trend of interest rates in the U.K. All we had ever done - and it was still worthwhile to do this - was to try to smoothen out fluctuations of a temporary nature i.e. not to go up or down quite as much as in Britain when it was thought probable that the movement there would be reversed within a short space of time. The basic position however, was that, with mobility of funds, competitive forces

required us to maintain a general conformity with British rates. This was something we had to accept as a fact of life and we could accept it the more readily because the absence of controls had clearly been working to our advantage as a net importer of capital.

I agreed with the Minister that no serious consequences had yet flowed from the maintenance of relatively low rates here in recent weeks. There had been a fall of the order of £30 million in external reserves since April but this could not be attributed exclusively to any one cause. It was my belief that more serious results had not occurred largely because of the inertia and inattention of depositors during a holiday period and their expectation that an adjustment would be made in due course. They would be led by past experience to expect that only a temporary deviation from British trends was involved. If, however, they came to believe that depression of interest rates here below their competitive level was a new long-term policy, the fat would be in the fire. It would not be prudent to wait until depositors became uneasy and decided to move their funds elsewhere. Once this occurred they would probably be slow to move them back again.

The Minister assured me that he had no new policy in mind. He was simply anxious to preserve for as long as possible the advantage to Irish industry and commerce of relatively low interest charges on bank indebtedness. He was in favour of watching the situation from week to week so that the adjustment to higher rates could be made as soon as circumstances required. I said I was unhappy with this week-to-week "brinkmanship" because it rested on an unsound foundation. A more prolonged holding down of deposit rates below the natural or competitive level was not, in my view, justifiable. It was not necessary from the point of view of achieving the settled national economic objectives and it was imprudent and even dangerous from the monetary standpoint, as well as causing distortions and inequities within the banking field. It was my judgment that the risk of a pronounced outward flow of resources was too serious to be undertaken for the sake of any benefit likely to arise from a purely short-term depression of lending rates. It had to be borne in mind that, if and when rates rose, all existing loan rates must go up. It was not necessary or desirable to stimulate any greater credit expansion than was already occurring. In the first four months of the credit year (i.e. from April to August) over £60 million of new credit had been made available to the private sector out of £110 million intended for that sector for the whole year under the Central Bank's credit advice. The distortion and inequity to which I had referred would be evident from the following figures for the April to August period - the Associated Banks had to do most of the lending in the period (£45 million as against £17 million by the non-Associated Banks) whereas the non-Associated Banks were getting most of the new deposits

(£32 million as against £29 million for the Associated Banks). It was simply because they could find no profitable outlet for their new deposits in Ireland at the lending rates operated by the Associated Banks that the non-Associated Banks were forced, for commercial reasons, to invest in Britain. It was a misconception to categorise the non-Associated Banks as being allowed to operate to the national detriment and to call for the application of "discipline" to them; the real inequity was in exerting pressure on the Associated Banks which affected their capacity to attract resources and at the same time put a strain on their liquidity. In fact, the success of the pressure, even temporarily, depended on the customers of the Associated Banks not being as sophisticated or sensitive to interest rate changes as the customers of the non-Associated Banks. The disparity in the characteristics of the customers of the two sets of banks was diminishing and one must expect that, sooner or later, the Associated Banks themselves would be in the same position as the non-Associated, that is, unable to hold deposits at uncompetitive rates and forced to adjust more quickly to changes in deposit and lending rates in Britain. All this was a logical consequence of the free movement of funds between the two countries, and if we wanted a different system we would have to envisage comprehensive controls which would not necessarily be very effective.

What I was saying, therefore, to the Minister was that a continued holding down of the rates below the competitive level was a dangerous game which we could not win in the long run and which was likely to be unprofitable from the national economic standpoint.

The Minister's main line was that, even though we could not maintain the lower rates indefinitely, we should do so for as long as possible for the sake of the costs relief this afforded Irish borrowers at a time when costs generally were rising. I argued that interest rates (net of income tax) were a small element in costs and the benefit would be short-lived in nature, by comparison with the serious consequences of any large-scale outflow of resources. I accepted the Minister's point that it was a matter of judgment how long a temporary moderation of interest rates here should last but I asked him in this matter to trust the judgment of the Central Bank because the immediate implications for bank liquidity and credit management were matters primarily within the responsibility of the Central Bank. I said I was reluctant to raise the jurisdictional issue but, as would be recalled from my January 1970 interview, I did hold strongly the view that once the Central Bank had aligned its credit policy with the Government's economic objectives, it should be free to decide how to apply it in detail from day to day.

The Minister pointed out that the movement of interest rates had implications for bank profits. I replied that these were, so far at least, not excessive and, moreover, were under active review by the Central Bank. The increase in deposit rates would tend to reduce profits, thus offsetting the effect of higher lending rates. On the general question of control of incomes

and prices, I stressed that the right course was the direct one of prohibiting by law the payment of income increases above the norm.

Mr. Murray suggested that what was involved was a pragmatic issue which could best be decided by a testing process. I argued, however, that, if one accepted the basic implications of the free flow of funds, it was unnecessary and dangerous to test the extent of the consequences which would ensue if interest rates were held below the competitive level. It was true that the external reserves were high and that this gave some scope for manoeuvre but any decision to run down the reserves should, in my view, be related to a better-considered and more lasting national advantage.

Finally, the Minister said he would consider the matter further and let me know his views through Mr. Murray in time for the Board meeting of the Central Bank in the afternoon. In fact, Mr. Murray told me prior to the meeting that the Minister had decided to acquiesce in whatever view might be taken by the Central Bank."

As a postscript to this satisfactory resolution of the jurisdictional issue, I reproduce an extract from the relevant Board Minute of 30 August 1972:

"The Governor reported on his visit to the Minister for Finance earlier in the day.....The Minister had agreed that, in view of the Central Bank's responsibility for credit management, he would accept its judgement as to the extent and time of any modification of the application in Ireland of changes in competitive British interest rates. He had, therefore, withdrawn his request for further deferment of change here and would acquiesce in whatever action the Central Bank deemed appropriate.

The Board agreed that there should be immediate consultation with the Banks' Standing Committee with a view to having an appropriate increase in rates made effective within the next ten days".

The following year, after the change of Government, the new Minister for Finance, Mr. Richie Ryan, T.D., said in a speech to Kildare Chamber of Commerce (4 April, 1973):

"It should be realised that the authority to determine bank rates is the Central Bank and not the Government....."

"Determine" was, of course, much too strong a word!

VII. CENTRAL BANK LENDING TO GOVERNMENT

The limited extent to which, in a small open economy, with a pegged exchange rate and free movement of funds, interest rates can be manipulated, given their necessary conformity in the end to international trends, is not of major significance from an economic policy standpoint. Much more importance attaches to the provision of finance for the Government by the Central Bank. It may well prove difficult to ward off attempts by the Government to ease its residual financing problems by obtaining money from the Central Bank. Originally, as mentioned in Chapter 1, many Central Banks were founded to meet this very need and, of course, theoretically there are circumstances in which the monetary authority is not only entitled, but in the interests of the economy obliged, to add to the active money supply in this or some less direct way.

At the same time, as the explosion in current budget deficits in the 1970's shows, to yield even a legitimate inch in financial matters may be to give an inordinate mile. "The appetite grows by what it's fed on" and, if a residual source of finance is too readily available to Governments, there is every risk of its being liberally drawn upon, whether the economic circumstances justify this or not. So there has, in my view rightly, been a strongly critical approach in Ireland, as elsewhere, to Government representations or demands for Central Bank accommodation.

It had been suggested in "Economic Development" (1958) that future additions to legal tender note requirements should be backed by Irish Government securities. This would have allowed only a small annual creation of credit by the Central Bank for the Government but would have recognised, to a minor degree, the State's seigniorial prerogative to issue notes as well as coin. Dr. Moynihan, who became Governor of the Central Bank in 1960, sponsored a more flexible proposition which at the same time protected the Central Bank's discretion, that of making a "balance in the General Fund" an eligible asset of the Legal Tender Note Fund and thus enabling money from the latter Fund to be siphoned into the General Fund which had power to invest in Irish Government securities. Legislative provision was made accordingly. It was, however, with great reluctance that the Central Bank yielded to a Government request for some £20 million of short-term funds in 1965/66, a time of difficulty in the dollar capital market.

Indeed, until the Central Bank Act, 1971, there was a first-line protection in that the Central Bank was not formally the Government's banker. This function had been the historical prerogative of the Bank of Ireland but it had, since the second World War, outstripped a single bank's capacity and had, in effect, been shared by the Associated Banks. These participated in Government financing, normally by way

of three-months Exchequer Bills, according to a deposits-related formula and with a limited right to rediscount these Bills at the Central Bank. The volume of Bills naturally tended to grow and from time to time a funding into medium-term stock occurred. The Associated Banks never displayed any marked eagerness to take up Exchequer Bills - or medium-term stock for that matter - and I have a vivid memory of the difficulties which Mr. Frank Aiken encountered, as Minister for Finance in the immediate post-war years (the "Daltonian Era"), in persuading them to extend cheap credit to the Government.

It is largely due to Dr. D.S.A. Carroll, first as Governor of the Bank of Ireland and then, since May 1970, as a Banking Director of the Central Bank, that Associated Bank credit for Government was fixed in scale, rationalised and largely legitimised. The secondary liquidity ratio, first appointed by the Central Bank in September 1972 at 31% (corresponding to the proportion of Associated Bank resources then held in Irish Government Bills and short-term securities) has since stabilised at 30% and has thus fixed, for both Banks and Government, the normal proportion of accruing bank resources to be allocated for Government purposes. The primary liquidity ratio - the proportion of banking resources to be kept in cash or with the Central Bank - was originally fixed at 12% for the Associated Banks. Although interest is paid on deposits with the Central Bank it is not as high a return as the Banks could earn on other uses of the money and a high primary ratio could, therefore, affect profitability as well as lending capacity. The ratio has been varied from time to time. Non-Associated Banks have been progressively subjected to appropriately differentiated primary and secondary liquidity ratios.

The secondary liquidity ratio is thus the automatic regulator of the banks' contribution to Government financing. It had been part of the arrangement in 1969 for centralisation of sterling holdings in the Central Bank that the Bank would aim at providing a dealing flexibility in the securities held by the Central Bank comparable to that which they had possessed in relation to British Government securities. This was largely achieved with the help of the Department of Finance, who agreed to diversify the choice of securities available in the three-months to five-years range. The Central Bank undertook the task of managing and, where necessary, supporting the market in such securities so that the Associated Banks would be assured of a high degree of flexibility and liquidity, as well as reasonable profit opportunities, so far as the securities held as "secondary liquidity" were concerned.

"Secondary liquidity" can become cash when the Central Bank agrees to rediscount Exchequer Bills or to buy other short-term Government securities from the banks. In this indirect way the Central Bank can itself replace the commercial banks as a source of finance for Government. Moreover, since it is now (since January 1972) the Government's banker, it can also directly finance the Government by providing it with overdraft facilities or by buying Government securities from the Department of Finance.

The virtually "clean sheet" situation in 1969 has already been remarked upon - only £3.6 million of rediscounted Bills held by the Central Bank in March 1969, apart from £20.5 million of 6% Funding Loan raised by the Government in 1965/66 and repaid fully before the end of 1969 (see Appendix 1). The amount of Exchequer Bills held by the Associated Banks grew to £102 million by March 1972 but this was within their secondary liquidity requirement and no Bills were under rediscount with the Central Bank at that date. It was only from 1972 onwards, and particularly after the quadrupling of oil prices at the end of 1973, that Government borrowing took a great leap forward and that the question whether the Central Bank should create money for the Government or whether the Government's residual needs should be met by foreign borrowing became a live and important issue, an issue made all the more difficult by the accepted need for some budgetary action to mitigate the constrictive impact of the oil crisis on economic growth.

Even in the course of 1972/73 it seemed for a time that the Exchequer would need much more from the banking system than the £50 million which "secondary liquidity" purchases by the banks were expected to yield. Mr. Murray wrote about an extra £20 million in September but the Central Bank took a more sanguine view of revenue prospects (a view which in the end proved right) and, though the Department remained pessimistic until the turn of the year, the demand for extra money eventually melted away.

However, before the end of 1973, Exchequer difficulties, despite large external borrowing, were such as to impel resort to the Central Bank for £25 million (later scaled down to £20 million) for general purposes, in addition to £8 million which the Bank had provided for the Exchequer to enable it to finance the Agricultural Credit Corporation. The Bank agreed to increase its holdings of short-dated Government securities. As soon as the arrangements were completed, I wrote (25 January, 1974) to the Minister for Finance to "clarify the Bank's position". The letter made the following points:

While the Central Bank had, once before - in 1965 - come to the aid of the Exchequer in a critical situation, it had always regarded such assistance as altogether abnormal.

The proper function of the Bank in relation to the Government consisted in making very short-term advances, repayable within a year at most, to the Exchequer, together with purchases and sales of short-term stock to support the market and to facilitate such changes in the money supply as were compatible with monetary policy.

In any given circumstances, there was a limit to the total amount of credit compatible with monetary order and the real growth needs of the economy. The financing of Government expenditure beyond this limit would have powerful inflationary implications and could entail countervailing and possibly harmful curtailment of credit for the private sector. An easing of monetary policy could only serve to aggravate the inflationary pressures emanating from the rise in oil prices and the operation of the national pay agreement. (Note: a considered statement of the Bank's views on oil-crisis policy appeared in the General Review chapter of the 1973-74 Annual Report).

While it seemed unavoidable that the Bank should assist the Exchequer at that time, its agreement to do so was given only with considerable reluctance. The Bank could not properly be regarded as a regular and substantial source of finance for the Exchequer. Indeed, reliance on the Central Bank as a major and continuing source of finance for the Exchequer would be at variance with the responsibility which the Bank must retain of regulating the total money supply so that it accorded with national economic objectives.....

Finally, the Bank expressed its hope and expectation that in 1974/75 and subsequent years Exchequer expenditure and resources would be so arranged that the question of resort to the Central Bank would not arise.

Notwithstanding this defensive volley, the Department of Finance found themselves constrained within a short time by the Government's reluctance to curb the Public Capital Programme to re-open the question of obtaining additional finance from the "banking system". The generic term "banking system" was doubtless used to cover both the commercial banks and the Central Bank. In the course of my reply to Mr. C.H. Murray on 27 February, 1974, I said:

"In a completely non-inflationary situation (with stable prices and no balance of payments deficit), there would, I think, be only one policy reason for adding to the expenditure financed by the community's current earnings and savings, namely, a desire to use national productive capacity more fully, assuming it was not already being fully used. In those circumstances, to pump new

money into circulation in a managed way, either through the banking system or by borrowing abroad, would make sense: provided it did not go too far, it would raise production without significantly raising prices, and any temporary deficit in the balance of payments would represent an import of capital to supplement current domestic savings and generate higher real income.

We are not at present in a non-inflationary situation: we have an exceptionally high rate of price increase and our 1974 balance of payments deficit on current account is expected to be well over £100 million. All the forecasts agree that, because mainly of energy and material shortages and external market conditions, our real productive capacity will be much lower in 1974 than in 1973. Whereas in 1973 the increase in GNP in money terms was of the order of 20% (about 12% prices and over 7% real), the corresponding figure for 1974 is expected to be much less, not more perhaps than 15% with a far smaller real element than in 1973. This is not a situation that can be remedied by pumping more money into circulation. The Central Bank considers that a much smaller increase in the money supply than in 1973 will be adequate to sustain productive activity at its real capacity level, given the external constraints operating in 1974. The greatest care should be taken not to exceed, whether by foreign borrowing or by domestic credit creation, the monetary injections required to meet the objective I have just defined. I assume that this objective represents Government policy. To allow such an excess would be to fuel the fires of inflation: the consequences would be seen in an acceleration of the rise in costs and prices and a further enlargement of the balance of payments deficit to the benefit of immediate consumption rather than of productive capacity.

Even the payments deficit already foreseen for 1974 may involve a drawing down of official external reserves, despite heavy foreign borrowing by the State and State bodies. I am not saying that some drawing down would not be tolerable. I would like, however, to draw attention to two facts (1) that the reserves (at £403 million) are today £40 million below the November, 1973, level and (2) that as against over 50% of imports in 1971-72 they now represent only between 35 and 40%. They are not as "comfortable" as they once were and any deliberate encroachment on them would not be wise with so many uncertainties ahead. By a deliberate encroachment I mean the injection of so much new money into the economy that the import over-spill and balance of payments deficit would be increased at the expense of the reserves.

I come back, therefore, to the position already explained in my letter of 25 January, 1974, to the Minister for Finance. In brief, the Central Bank will play its part, within the context of the macro-economic forecasts agreed from time to time, in providing the requisite liquidity for the commercial banks. This

will enable these banks to extend credit to the extent necessary to achieve the economic aims implicit in the forecasts, namely, as high a level as possible of domestic production without accelerating the already high and inescapable rate of increase in costs and prices or aggravating the outside deficit already envisaged in the balance of payments. It is our estimate that the amount of bank finance which will accrue automatically to the Government under the established "secondary liquidity" ratio is of the order of £65 million. If the Government were to demand more, this would have to be separately negotiated and would be at the expense of the credit available to the private sector. The Central Bank could not reasonably be expected to support any move which would be incompatible with basic policy objectives or would involve harmful restrictions on credit for private productive purposes.

In general, the Central Bank cannot be regarded as a direct source of permanent finance for the Exchequer. The fundamental problem is not, in fact, the financing of public expenditure (acutely difficult though that is) but the excessive rate of increase in such expenditure. A £397 million Public Capital Programme would imply an increase of some 20 per cent. as against a forecast growth in GNP of only 15 per cent. In the period 1970/71 to 1972/73, inclusive, the public capital programme grew at an average annual rate of about 13 per cent. compared to average GNP growth of some 14 per cent. When one considers the massive increase of over 30 per cent. in the public capital programme in 1973/74, and the fact that the thrust of such expansion will continue to be felt well into the second half of 1974, it would be difficult to justify the need for any further stimulus, even in more normal economic circumstances. The projected opening deficit on current account seems even more incongruous, implying a growth in current Government expenditure of well over 20 per cent. compared to an annual average growth of less than 17 per cent. in the period 1970/71 to 1972/73 inclusive. Taking the proposed capital and current expenditures together, these could constitute a record 46 per cent. of GNP in 1974. If a large part of this expenditure were to be financed by the banking system the growth in monetary aggregates could not be kept within tolerable limits. The private sector will require substantial funds for working capital to meet escalating wage and raw materials costs and special provision will have to be made for the hardening of trade credit by foreign suppliers. These are new factors over and above the normal borrowing needs of the private sector. Accommodation of the Government's projected borrowing requirements could result only in an escalation of the monetary aggregates beyond the real needs of the economy, or in a severe cut back in essential credit for the private sector.

I hope I have made clear how powerful and dangerous an inflationary influence can be exerted, once the use of productive capacity is maximised, by financing further expenditure either from the proceeds of external borrowing or from domestic credit

creation. I would like to add a comment on the prospects of raising abroad the kind of residual finance required by the Public Capital Programme alone, even if the Current Budget were balanced. A figure of the order of £67 million is mentioned in the Minister's memorandum. This would be in addition to £55 million being sought by the State bodies and £19 million Government borrowing from the World Bank and the EIB. I do not believe it is feasible for Ireland to raise sums of this magnitude abroad over a twelve month period. Attempts to do so would be treated with growing reserve in world capital markets and would bring into question the soundness of this country's financial management. This could well have the effect of jeopardising the prospects for any sizable borrowing abroad in subsequent years.

To conclude, it is the objective of monetary policy to support economic growth as far as is feasible. Disproportionately large increases in public expenditure, financed by borrowing from the banks and abroad, which result in total expenditure being excessive in relation to the growth in real output have most serious inflationary consequences. The projected increases in current and capital expenditure for 1974/75 run far ahead of the rate of growth of resources envisaged, even in money terms. Capital expenditure by the Government and the financing of current deficits has in recent years increasingly relied on residual borrowing from the banking system and from abroad, with the share financed by sales of securities to the non-bank public and small savings experiencing a sharp decline. At the same time the State bodies have also had increased resort to foreign borrowing. On the basis of the memorandum these trends would become even more pronounced in 1974/75. In these circumstances, it would not be appropriate to expect the Central Bank to provide fresh finance for the Exchequer. To do so would involve a disregard of the obligations placed on it by statute to safeguard the integrity of the currency. The Central Bank considers that monetary policy should be aimed at moderating inflationary pressures while at the same time supporting a sustainable rate of growth of the economy. It would be undesirable and improper that Central Bank credit-creation should itself generate additional inflationary pressure".

So that the financial year might coincide with the calendar year, as in other EEC countries, budgetary dispositions were made in 1974 for the nine months April to December and the financial year was brought into line with the calendar year from 1975 on. For the nine months to December 1974, the budget deficit on current account came to £92 million, compared with £11 million for the year 1973/74. It soared to £259 million in 1975 and stayed above £200 million in both 1976 and 1977, with explosive effects on Government borrowing requirements. The Central Bank helped towards financing the needs of the "short year" 1974 by introducing a secondary liquidity ratio for the Industrial and other Banks (who had hitherto been exempt) and this produced close on £20 million for the Exchequer. There was also a provisional

commitment on the part of the Central Bank to purchase some £20 million of Government securities from the public in order to ensure adequate domestic liquidity but, in the event, the Government's foreign borrowing exceeded original expectations to an extent which obviated any need to create liquidity by direct Central Bank action.

It will be no surprise, however, that the Central Bank should again be seen as a possible source of much-needed Government finance in 1975. The Bank found itself in a quandary on valid economic grounds. It could, and did, argue strenuously for what it considered to be the right budgetary policy but once budgetary decisions were taken, and the extent of total Government borrowing thus determined, the Central Bank had to consider what were the least objectionable ways of meeting the given requirement. This might well mean altering the balance between foreign borrowing and domestic credit creation. There was little point in the Government undergoing the "discipline" of foreign borrowing when such borrowing was all too easy and had the effect in part of building up external reserves. In 1975 there was a particular tactical reason for reducing rather than increasing these reserves: we were interested in qualifying for access to the Oil Facility (easy-term loans) organised by the International Monetary Fund.

So, on 6 March, 1975, in a letter to Mr. C.H. Murray I was admitting that the circumstances called for "a degree of flexibility in responding to the immediate situation":

"The problems of financing the external deficit and the fiscal deficit are linked in the area of foreign borrowing. In the Bank's view it is necessary this year, in the best interests of the country, to direct attention primarily to the financing of the external deficit and to regard the implications this may have for Exchequer finance as a secondary consideration. On the other hand, it would not be appropriate to have resort to external borrowing to finance the Exchequer deficit without due regard to the implications this might have for the nature and extent of the external indebtedness of the economy as a whole and for its continuing creditworthiness abroad. The existing level of external indebtedness and the current and prospective need for further substantial foreign borrowing are such that it is essential to ensure that the extent, the cost and the risk of any such borrowing are kept as low as possible. Therefore, we feel that the amount of foreign borrowing this year should, at most, be no more than adequate to maintain the external reserves at their end-December 1974 level. Further, it would obviously be beneficial to defer official borrowing as ^{far} as practicable in order to bring about a temporary decline in reserves and thus help to establish Ireland's eligibility to benefit under the IMF oil facility for 1975. For its part the Bank is sufficiently convinced of the appropriateness of this approach to be willing to assist the Department in the financing of the residual fiscal deficit of £258 million that emerged from the

budgetary dispositions in January. As you know, officers of the Bank and the Department of Finance have been discussing this matter and it has been indicated that the Bank would be prepared to make available to the Exchequer a sum of £72 million less the amount (not exceeding £17 million) of any excess of sales of Government securities to the non-bank public over the £30 million estimated for such sales at the time of the Budget.

The Bank would regard the extension of finance of this magnitude to the Exchequer in a single year as a quite exceptional measure which could be justified only by advertence to the special immediate needs of the economy. As you know, when the Bank decided in January of last year to make £20 million available to the Exchequer I wrote to the Minister that "while it seems unavoidable that the Bank should assist the Exchequer at this time, its agreement to do so is given only with considerable reluctance. The Bank cannot properly be regarded as a regular and substantial source of finance for the Exchequer. Indeed, reliance on the Central Bank as a major and continuing source of finance for the Exchequer would be at variance with the responsibility which the Bank must retain of regulating the total money supply so that it accords with national economic objectives and does not accentuate inflationary pressures".

I must, therefore, make it clear that the Bank's willingness to provide this year the substantial amount I have indicated is predicated on a certain understanding regarding economic policy objectives and related budgetary dispositions. Specifically, the residual fiscal deficit of £258 million emerges from, inter alia, proposed levels of expenditure and revenue that are taken to be compatible with declared economic policy objectives. In formulating monetary policy, the Bank has accepted these objectives as reasonable in prevailing conditions and its policy is directed to support their attainment. The residual fiscal deficit is also related to estimates of other "traditional" domestic borrowing sources, including the product of the banks' secondary ratios, and the Central Bank has taken account of this factor also in its monetary policy dispositions.

I know that you recognise that it is essential for the effective exercise by the Bank of its monetary policy function to be able to rely upon some reasonably firm expectation regarding the level of official external borrowing. Moreover, when, as in the circumstances of this year, the Bank is willing to extend substantial direct support to the Exchequer it must qualify its willingness to do so by making it dependent on substantial adherence to the declared fiscal dispositions. These, as you know, form an important part of the framework in which the Bank has set monetary policy. The Bank's primary concern must always be to fulfil its statutory responsibility.

In summary, the Bank's position is that it is willing and anxious to respond to the exceptionally difficult circumstances of the current year by a substantial departure from its normal position in regard to lending to the Exchequer. It is convinced of the need to limit official foreign borrowing to an agreed figure which would be no more than that estimated to be necessary to maintain the level of

the existing monetary reserves, which would be compatible with the objective of gaining access to the IMF oil facility and which would moreover provide a more secure basis for the effective exercise of monetary policy. Against this background the Bank is willing to contribute to the financing of the residual borrowing needs of the Exchequer to the extent that I have indicated, provided there are no substantial departures from the already budgeted levels of public expenditure and revenue. In this respect the Bank is not, of course, seeking to exercise an unwarranted influence on Government policy. Its purpose is rather to safeguard its statutory role in relation to monetary policy, that is to avoid a situation in which it would be committed to the support of emerging fiscal dispositions without regard to their broader economic and monetary implications.

Some correspondence followed as to what would be regarded as a "substantial" departure from the budgeted levels of public expenditure and revenue. The Bank indicated that this was a qualitative rather than quantitative concept but that an increase of £20 million in expenditure would be so regarded. A provisional accord was reached with the Department of Finance, though I was emphasising to Mr. Murray on 11 April, 1975, that the Bank must avoid an unqualified commitment to support emerging fiscal dispositions which might be inconsistent with the economic policy objectives which monetary policy seeks to support". I suggested that the entire situation be reviewed before the end of May. When the situation was reviewed in May access to the IMF Oil Facility was accepted as no longer open and the Bank's attitude softened. Agreement was given to a temporary increase in the overdraft limit to £83 million, to be reduced to £25 million by the end of June.

The Bank's report for 1975 recorded that in the previous year, when Exchequer borrowing abroad amounted to about £160 million, the external monetary reserves rose by £60 million. "Although it would not be inappropriate that reserves should over time increase proportionately to external payments and liabilities, the Bank takes the view that it would not be in the best interests of the economy in 1975 if official foreign borrowing were undertaken to an extent - if practicable - which would cause a substantial increase in the external monetary reserves. Rather should attention be given primarily to the optimum financing of the economy's external current deficit, official foreign borrowing being limited to such an amount as would not entail any significant increase in the external monetary reserves".

A restriction of foreign borrowing to the minimum was stated to be desirable on various grounds:

"Rapidly increasing external indebtedness would call into question the economy's continuing creditworthiness and increase the costs of foreign borrowing, including those arising from the appreciation of currencies in which it is necessary to borrow. It could reduce Ireland's freedom of action in regard to economic policy and could give rise to refinancing difficulties when loans matured. Foreign borrowing, in any case, entails a transfer of income abroad in order to service and repay the debt and this burden becomes all the heavier if the original borrowing has not been incurred for productive purposes".

The Bank went on to state that adoption of the policy of not borrowing more abroad in 1975 than was needed to maintain the external reserves at or about their end-1974 level carried with it certain technical consequences. The Government's financial needs had to be met to a greater extent from domestic sources but arranging for this presented "no problem of principle" for the Bank, provided the basic economic objectives for the year were adhered to, public expenditure and borrowing were kept within the June Budget framework and at least the incomes restraint proposed in that Budget were made effective. It was essential that these aims be realised if a start were to be made in winding down the rate of inflation. So long, however, as these objectives were pursued, the particular financing methods adopted were "primarily of technical significance". The immediate effects on the money supply and bank liquidity of financing Government expenditure in part through the Central Bank were "much the same as when recourse is had to external borrowing". The Bank was, therefore, prepared to help in financing the Exchequer borrowing requirement, though it reiterated that it could not be regarded as a permanent source of finance for the Government and "must ensure that the level of the official external reserves is adequate, in 1976 and later years, to finance the higher deficits which will be associated with a resumption of economic growth".

In fact the Government drew £50 million from the Central Bank in 1975 through increased purchases by the Bank of short-term Government securities. Flexible use was also made of the overdraft facility which had first been arranged in July 1974 subject to a maximum of £25 million. To ensure that the overdraft did not become a permanent source of Exchequer finance it was stipulated that the account be in credit for at least 30 days in every year. The Department of Finance sought in July, 1975, to have the limit raised to £75 million or be left open-ended but this request was refused.

"If, as you suggest, this facility were trebled or left open-ended", I wrote to Mr.C.H. Murray on 28 August, 1975,"the finance provided could no longer be regarded as temporary. With the scope for utilisation greatly increased, it is likely that the average utilisation would rise *pari passu*. This would leave the Bank in the unacceptable position of providing the Exchequer with what would virtually be hard-core finance at a level which it could not anticipate and over which it would have little control". The Bank stood by its original offer to increase the limit to £35 million but later in the Autumn raised it to £40 million. Indeed, as a quite exceptional and temporary measure, it allowed the overdraft to run to £70 million to finance "intervention" purchases of beef and dairy products pending arrangements for the financing of such purchases by the Associated Banks on foot of discountable Bills.

The Bank's grudging reaction to demands for money for Exchequer purposes was a function of its apprehensions about the rapidly deteriorating state of the public finances. The Bank was particularly out of sympathy with the deliberate incurring of massive deficits on current account - see Chapter V above and my speech in Seanad Eireann on 25 January, 1978, (Cols. 22/24). Even in March 1974 I had written a note to Mr. C.H. Murray which concluded with the words: "the ballooning of the uncovered Exchequer borrowing requirement.....leaves me with the uncomfortable feeling that effective management of our financial affairs is slipping out of our hands. I have not had this feeling so strongly ever before". The Exchequer borrowing requirement had risen from £295 million for 1972/73 to £883 million for 1975, with the prospective need for 1976 even higher. Foreign indebtedness already exceeded total external reserves.

In October and November of 1975 the Department of Finance had discussions with the Central Bank on the problems of Exchequer financing. Even allowing for £100 million from the Banks through purchase of Government stocks to make up their "secondary liquidity" ratio, there was still some £400 million of residual borrowing to be effected either externally or from the domestic banking system. The Central Bank made it clear that there could be no significant increase in the credit available for Government needs from the commercial banks and, as far as Central Bank finance was concerned, that "it could not commit itself beforehand as to what it might provide". "We would have to see the entire picture - fiscal and incomes - before we could assess our role, if any, in the financing of the Exchequer".

This stand against making any precise commitment in advance seemed essential if the Bank were not to be expected by the Department of Finance (and the Government) to become a regular contributor on a massive scale to Exchequer financing, thus losing any discretion as to the circumstances in which a limited amount of assistance might be

deemed appropriate by the Bank itself. One of my last acts as Governor was to write (19 February 1976) to Mr. C.H. Murray as follows concerning Exchequer borrowing requirements in 1976. I did so "following careful consideration of the matter at Board meetings on 4 and 18 February":

"The Board wishes me to reiterate its view that the Central Bank can properly play only a minor and residual role (if any) in financing the Exchequer on a long-term basis. Any prior commitment to make a major or regular contribution to Exchequer financing would compromise the Bank's discretion in exercising its responsibility to try to manage the money supply so as to safeguard the integrity of the currency.

Recognising the extent of the Exchequer borrowing requirements in 1976, and assuming that the pay pause desired by the Government will be made effective, and a medium-term recovery plan set in motion, the Board confirmed the indication given in my letter of 27 January that the Bank would be prepared, if necessary, to provide finance for the Exchequer this year to about the same extent as in 1975, i.e. £50 million.

Beyond this, however, the Board is unwilling to commit itself because of the principle outlined above and the uncertainty surrounding attainment of the Government's basic economic objective, which the Bank shares and wishes to support, namely, that of curbing inflation sufficiently to safeguard competitiveness and increase output and employment. On the home front, this uncertainty relates particularly to the question whether there will be a pay pause. Regrettably, this matter was not resolved before the Budget and appears likely to be in doubt for some time yet. There can, therefore, be no assurance that present budgetary dispositions, and monetary arrangements aligned with them, would be directed towards achievement of the basic economic objective. Indeed, there would be considerable risk that any easing of access to additional money would operate against the interests of the economy in the situation with which it may be confronted during 1976. If, on the other hand, a pay pause is made effective and, in pursuance of a firm and phased programme, there is evidence of progress in restoring the competitiveness and growth of the economy, the Board of the Bank would consider it appropriate to review the extent to which the Bank might assist, during the period of reform, in moderating the need for resort by the Exchequer to external borrowing.

The Bank has already, in its Report for 1974 and in its Summer Bulletin, 1975, recognised the similarity, in terms of technical consequences and effect on the money supply, of the residual financing of Exchequer requirements by the Central Bank and through foreign borrowing. Indeed, the Bank has indicated that foreign borrowing carries such disquieting implications that it should be kept to a minimum

and incurred only for capital purposes. This requires primarily that the total public sector borrowing requirement be curbed and as much of it as possible supplied from domestic non-bank sources. It also requires implementation of the "firm intention" of the Government, as declared in the Minister's budget statement on 28 January, "to phase out the present current deficit over a three-year period". Where, despite attention to these principles, a large borrowing requirement still remains, it is undesirable to supply it entirely by foreign borrowing if this would have the effect of adding unnecessarily to external reserves. In these circumstances, the lesser evil may be to supply a part of the residual Exchequer needs from the Central Bank.

It is on this reasoning that the Central Bank has come to the aid of the Exchequer to a limited, but not insignificant, extent in 1975 and is prepared to offer similar help this year. At the same time, it should be said that the Bank is not convinced that, even if all the residual needs of the Exchequer were to be met this year by foreign borrowing, the external reserves would grow excessively, having regard to the various factors which may operate adversely on the reserves over the period ahead - replenishment of stocks, the increase in foreign debt service, possible reverse flows of capital, and the enlargement of the trade gap which will be associated with a resumption of economic growth".

There I must leave the matter and let someone else tell the story of the Bank's subsequent reactions to Government pressure for financial support. As I write this (end 1978), it would seem that the Bank has so far been able to keep within the principles outlined above.

V111. ADVICE AND COMMENT, Mid-1972 - End 1973

Already in July, 1972, the Minister for Finance, Mr. George Collesy, was warning the Government of the serious current account deficit in prospect for 1973/74 and calling for a revision of non-pay provisions. He was, however, compelled to report by the end of September that the results of this revision had been "most disappointing". On the pay side, moreover, costs were rising and it was the intention to use most of the net Exchequer benefit of EEC membership to bring social services more into line with the level in Northern Ireland. A gap of some £40 million on the current account of the 1973/74 budget still threatened, though the deficit in 1972/73 would be much less than originally envisaged. Economic considerations did not support the incurring of a current deficit in 1973/74, particularly as the substantial increase proposed in public capital expenditure would be a strong boost to economic growth. The current account gap should, therefore, be closed by increasing taxation, reducing expenditure or a combination of both. The Minister favoured principal reliance on cuts in current expenditure but had not secured formal Government approval of any major reductions before the General Election in March 1973.

On 1 January, 1973, Ireland became a member of the EEC. In the light of this significant change in our economic circumstances, I wrote to the Minister for Finance on 22 January, 1973, stressing that our relatively high rate of inflation (9% against an average of 6% for the Six) was a recipe for trouble; that our being in line with Britain in this respect was "cold comfort" as we had not joined the Community to become more dependent still on the British market; and that we needed a high rate of growth to provide employment and catch up in living standards with the rest of the Community. The letter argued that a policy of supporting growth by fiscal and monetary means against the background of a relatively high inflation rate was doomed: our manufactures would become unsaleable and our hotels and guesthouses too dear for foreigners. The Irish pound could come under strain even in relation to sterling. Competitiveness in the Community might be temporarily regained for our exports by devaluation against all Community currencies but only at the cost of additional price increases resulting from dearer imports, dearer food and, before long, compensatory wage claims. "In this direction one could see only a vista of repetitive devaluations".

The letter continued:

"The only sound basis for an expansionary economic policy, bringing the largest gains in jobs and living standards, is a competitive price level based on domestic cost moderation. This means getting down as soon as possible to a rate of price increase of not more than, say, 5 per cent. per annum. The current rate at which costs of production are rising is impeding the growth of employment and aggravating the incidence of redundancies.

How can this winding-down of price inflation be achieved? Obviously not without simultaneously keeping up a high rate of output and reducing the rate of money income increases. The aim, on the one hand, must be to ensure that productivity gains will be as high as possible and, on the other hand, that cost increases arising from money income increases will be as low as possible. A special, but purely temporary, offset to the cost effect of high income increases is provided by the exceptional productivity gains secured when output is rising to its normal potential, as at present.

It is a discouragement to anti-inflationary action that money incomes in the form of wages and salaries are predetermined for 1973 and varying parts of 1974 by the latest National Wage Agreement. Nevertheless, policy-makers should see the urgency of trying to ensure, by action now, both (a) that the National Wage Agreement will not explode under the pressure of the current high rate of food price increases and (b) that it will be followed only by such a rise in money incomes as will safeguard our competitiveness. Otherwise, there is a real danger of becoming victims of drift, with no effective influence on a worsening situation.

It is admittedly difficult to persuade trade unionists to be moderate in pay demands in the light of the current rate of price increase - to bring them to accept that such moderation would lead to a lower rate of price increase in the future, yield a probably bigger improvement in pay in real terms, and be better for the country because it would increase export and employment prospects.

Yet if money incomes keep rising at the rates we have experienced in recent years, so surely will prices keep rising at 8 or 9 per cent. per annum. Apart from any other effect, this rate of inflation would reduce the value of a pound to 50 pence in eight years.

The fact is that a persistent tendency to inflation is associated with the nature of the modern economy itself. Social ambitions and conflicts, under partly monopolistic conditions of both industrial and labour organisation, lead to a combination of inordinate income and price increases, inflationary reactions to tax increases, trade union indifference to high levels of unemployment, and continuous depreciation of money. The extent to which inflationary pressure becomes economically or socially destructive depends on the political capacity of governments to achieve consensus or acquiescence in the multiple measures necessary to contain it.

This consensus or acquiescence seems more likely to be obtained in the broader context of economic and social development policy over a period of years ahead than in confrontation over particular pay rounds. In recognition of the socio-political dimensions of the incomes/prices problem it is most desirable to have early discussions with the trade unions on Ireland's prospects in the early years of EEC membership, as indicated by a well-articulated outline plan or plans, so that they (who are committed to the principle of planning) can satisfy themselves that prospective resources will be fully and effectively used, discuss the conditions under which this use of resources can be realised and the priorities to be observed in the allocation of additional national output. Discussions of this kind must involve consideration of the prospective price increases over which Ireland will have no control - whether for imports or agricultural products - and the highest over-all rate of increase in money incomes which, allowing for all the price effects, may still assure us a competitive position so that we can realise our full output potential. An approach of this kind would

recognise that the time-span of a sustained counter-inflationary programme probably runs to three years or so, thus coinciding with the period of the Fourth Programme, the emphasis of which will necessarily be on adjustment to EEC conditions. In this context it will be essential to spread understanding of the fact that the extent of the real improvement in individual and social standards which the Irish community can achieve depends on the amount of its additional production of saleable goods and services.

Education, persuasion and appeals to responsibility in regard to the evolution of money incomes must have priority over attempts at control, though some form of control, if only to safeguard majority consent to reasonable norms, has to be envisaged. The consensus or acquiescence mentioned above was "in the multiple measures necessary to contain inflation". Containment of money income increases on an intelligent and voluntary basis is greatly to be desired but it would be more realistic to establish a regulatory process based on appropriate institutions and on legislation.

Unless income increases are effectively restrained, a rational solution for inflation is impossible. By a rational solution is meant one that ensures that production and employment get priority and that the damaging restrictions involved in fiscal or monetary "squeezes", and the communal loss suffered through devaluations, are avoided."

I ended by explaining that I had laid all the emphasis on incomes and prices because the scaling-down of our excessively high rate of inflation was the predominant and most urgent requirement in order to safeguard economic and social progress.

Following on a talk I had given to the ITGWU on 14 December, 1972, this letter gave expression to ideas concerning the possible relationship between medium-term planning and consensus on improvements in pay and social standards which were later developed both in my own letters and talks and in the Bank's bulletins and reports. A representative selection of extracts from the latter is given in Appendix 3. In the Spring of 1973 when the Departments of Finance, Labour and Industry and Commerce were concerting an aide-mémoire on incomes policy, I spoke and wrote several times to Mr. Murray on the desirability of the Government's finding a wider context for pay discussions. On 21 February, 1973, I expressed my belief that "a policy initiative of longer term and

wider scope would stand a better chance of acceptability and success". I went on:

"The National Pay Agreements are essentially the result of a periodic bargaining confrontation between employers and trade unions. They are almost certainly determined on the basis of short-term considerations, such as the market conditions for goods and labour which the parties expect to encounter in the ensuing year and a half and the degree of militancy among the trades union membership with regard to wages. The National Employer-Labour Conference is scarcely equipped to determine, and in any case does not have as its primary objective, a national agreement on incomes which would necessarily be conducive to the maximisation of economic welfare by reference to employment, income distribution and economic-growth objectives.

The process by which guidelines emerge is as important as the guidelines themselves: the real aim is to promote a general understanding and (hopefully) acceptance of certain constraints. I believe that the discussion in NIEC which led to the Report on the Economic Situation 1965, in which the principles of an income and prices policy were first reviewed,* had an influence in curbing expectations prior to the 10th Round. I doubt if a set of incomes guidelines, generated exclusively within the machinery of Government, formulated on an undisclosed analytical basis and without the opportunity of public discussion, would influence in any decisive way the behaviour of unions or even of the Employer/Labour Conference. Nowadays the enlisting of public and institutional support for economic policy strategies requires, I believe, the provision of information about the consequences of alternative choices and the presentation of a strategy for economic development which will cover a period of some years. Inflation is an expression of deep-seated conflicts and ambitions in our society and it is only if the mastering of inflation is set in the context of strong economic growth and significant social improvement that the requisite constraints have any chance of being accepted.

For these reasons, I regard the Fourth Programme as probably the best (if not the only) means of attempting to secure the degree of consensus on economic and social development which might make possible a rational solution of our major economic problem - which is the higher rate of inflation of money incomes and prices in Ireland than in most other Western countries. Acquiescence in the measures needed to contain inflation seems more likely to be obtained in the broader context of economic and social development over a period of years ahead than in confrontations over particular pay rounds. As there is at present no NIEC or NEC, I hold the view that the Government should have *ad hoc* consultations with the unions in particular (but also with management) on the potentialities and conditions of economic development

*Note: NIEC Report No. 27 (on Incomes and Prices Policy) gave more extended treatment to the subject.

and social progress over the years ahead and the prices/incomes relationship which offers the best hope of realising our full output potential.

I should add a word on what seems from experience to be an obstacle to the widespread acceptability of any plan handed down by Government, namely, its necessarily political nature and purpose. I wonder if it would not be desirable that a non-Government body, such as the E.S.R.I., should be given the task (with the help of factual information from Government departments and other agencies and with due regard to E.E.C. medium-term programme and relevant policies) of formulating, say, three alternative but plausible growth-rate possibilities for a few years ahead, indicating the conditions (including the evolution of prices and incomes) underlying each of them. These outlines of potentialities could be studied by all interested parties and would serve as a basis for socio-political argumentation. What the Government eventually issued as its programme would then be seen to be the essentially political document which a comprehensive and coherent set of Government policy statements must be; and it could be assessed against a more informed background.

I would rather see us directing our thoughts towards the future on these lines than doing much further analysis of what has happened in the past. I am heartened by the extent to which the views I have been expressing recently (and those of NIEC Report No. 27) are shared by Aubrey Jones, former head of the British Prices and Incomes Board. His article in the Sunday Times of February 18, 1973, contains the following interesting paragraph, amongst others:

"An assembly of "interests" say, a National Economic Development Council or some sub-committee of it, is therefore desirable because the rules have to appear fair: to appear fair they have to be demonstrated to be grounded in reason; the demonstration can emerge only through debate. For this purpose a forum is required. Where there is no such assembly a Government has to guess as best it can what will carry assent."

What Jones said about sanctions is also of interest: as you know, I have always favoured the underpinning by statute of agreements reached voluntarily by a majority, so that dissident minorities or mavericks will not be able to wreck such agreements with impunity."

Mr. Murray replied on 23 February:

"Thanks for your views of 21 February on the aide-memoire regarding incomes policy. These will be most useful in the discussions to come.

The preoccupation of the aide-memoire with the Employer-Employee Conference reflects the importance attached by the Unions to this body, and the burden of official advice that the Conference is the starting point for any attempt to explore the possibilities of a change in the present system. This does not, of course, rule out the question of the Government having at some stage direct ad hoc consultations with the two sides of industry.

I am not greatly enamoured of the suggestion that a body such as the ESRI should be asked to and assisted in formulating, say, "three alternative but plausible growth rate possibilities for a few years ahead." There would almost inevitably be controversy, and possibly confusion, when the Government's own programme appeared later, and I doubt whether, on balance, this would be helpful. Of course the ESRI could do the job off its own bat, but I'm not sure whether it would have the information (available to Departments and State bodies) to make the exercise a worthwhile one."

I made a further comment on 27 February:

"The second and third paragraphs of your letter of 23 February are rather discouraging. I do hope that the Government will find a wider framework and time-scale in which to set an incomes policy and I consider it equally essential that economic and social programmes should no longer be handed down as unique prescriptions of Authority but be the subject of advance consultation with major interests to whom a reasonable set of options would be presented. Intelligent discussion and argument need not lead to controversy and confusion, and, in any case, are vital elements in a democratic process aimed at consensus."

Mr. Murray's reply, apart from certain disclaimers, emphasised that the comments in the third paragraph of his letter of 23 February related solely to the rôle envisaged by me for a body such as the ESRI. On 28 February I had a letter from the Secretary of the Department of Labour (Tadhg Ó Cearbhaill) which expressed sympathy with the wider approach I had suggested, and particular interest in focussing the minds of the Trade Unions on the primacy of job creation and conservation against "our background of unemployment and emigration". Mr. Ó Cearbhaill feared, however, that the attitudes of the Unions to enshrining a pay agreement in binding legislation would be so hostile as possibly to

"kill the negotiations from the onset".

It is relevant to recall that there never was a Fourth Programme and that it was only in 1977, when the Coalition Government, which took office in March 1973, was replaced by a new Fianna Fáil Government, that medium-term planning was resumed.

The 1973 budget, in fact, was presented by the new Minister for Finance, Mr. Richie Ryan, T.D. In a letter of 15 March, 1973, congratulating him on his appointment I mentioned that industrial output, personal consumption and imports were all rising markedly and that strong inflationary pressures existed on the incomes side. I sent him a copy of my letter of 22 January to his predecessor and also of documents bearing on the relationship between the Central Bank and the Government. I promised to send more specific views when I received confidential information on budgetary prospects.

One of the first actions of the new Minister was to submit memoranda to the Government on inflation and on the budgetary position as he found it - he promised to make further proposals for cuts in current expenditure but broadly accepted the increased capital provisions already proposed, though he stressed in a later memorandum the financing difficulties involved. The memorandum on inflation attempted to assign relative weightings to external and internal causes; it estimated that for every 1% rise in total domestic money incomes, unaccompanied by any increase in output, the price level might be expected to rise by 0.6%.

In a brief and mild comment to Mr. C.H. Murray on 2 April, 1973, I said: "The proposed increase in the public capital programme for 1973/74 will be a strong additional stimulus to aggregate demand." This raises a serious question as to the desirability of any significant deficit in the current budget for 1973/74, in view of the risk of over-stimulation of demand and the creation of inflationary pressures in addition to those already operating on the side of costs". I added that I would like to know in confidence of budgetary intentions so as to be in a position to offer comment before they took final shape.

Mr. Murray's response indicated that the Government's pre-election commitments were likely to create a current account deficit of over £60 million but that he would be discussing with me his "menu" of possible measures to minimise this deficit. He also sent me a note he had prepared on budgetary policy, including the question of incurring a deficit on current account. In my reply on 19 April I said:

"Regrettably, the budgetary position this year seems largely predetermined by pre-Election commitments. It is a situation in which expenditure will increase at a rate far in excess of the growth in GNP and in which the borrowing requirement (from the banks and abroad) would, on the basis of unchanged tax rates, increase by £74 million to £155 million. The size of the borrowing requirement is probably the best indicator of the effect on demand of the Government's financial operations. Such an increase in the expansionary influence of the current budget and public capital programme this year is not, in my view, justified by the needs of the economy: the growth rate is rising to a satisfactory level, unemployment is falling, demand, in the form of consumer spending, investment and exports, is already increasing rapidly, with at least one major form of investment (building) already pressing hard on skilled manpower availabilities. In these circumstances, every possible effort should be made to reduce the borrowing requirement and, in particular, to minimise the extent of the current budget deficit.

With this in mind, I recommend that the implementation dates of increased expenditure commitments be delayed until the latest acceptable date in the financial year.

Where the Government is not bound by any commitment to increase or maintain expenditure, I would expect that every effort will be made to achieve worthwhile economies. If, nevertheless, an enormous deficit still remains there may be no option but to reduce the deficit by additional taxation but this should be of a kind which will have the least effect on the consumer price index. I support the case for extending income tax to all occupations. Bringing all income earners within the scope of income tax is desirable in equity and is necessary if income tax is to become an effective second pillar of the revenue structure.

Now that the economy is experiencing a distinct improvement in the employment and growth trend, the urgent and predominant concern of economic policy should be to wind down inflation from its present 9 per cent. level. The reasons for this were outlined in my January letter to the previous Minister and are repeated in the Bank's current Bulletin. A large budget deficit on current account, together with an increase of some £50 million in the public capital programme, and a total "residual" borrowing requirement of £155 million, could not but increase inflationary pressures by causing a further increase in the level of aggregate demand. Moreover, a substantial budget deficit would be associated in the minds of the public with continuing inflation at a higher rate than in Britain and the rest of the EEC and would thus strain public confidence in economic policy and in the future of the economy. It is on the reduction of the inordinate rate of increase in expenditure that effort must be concentrated if public finance decisions are to make a positive contribution towards the control of inflation.

It is urgently necessary also that preparations be made for the achievement of a moderate increase in employee incomes as the current national pay agreement expires. Success in the effort to come to grips with the fundamental domestic source of inflation, labour-cost increases, is more likely to be achieved in a wider context than confrontation over the next wage round. I have already stated several times in recent months my views on what that wider context should be.

I would be glad if you would show this letter to the Minister.

P.S.

Thank you for sending me the latest OECD survey of Ireland. I am pleased to find in it independent support on such matters as (1) the propriety of looking at the economic effect of the whole budget, not just the current deficit (2) the abundance of expansionary potential on the public capital expenditure side alone (3) the desirability of presenting ex-post as well as ex-ante budgetary estimates and, above all, (4) the desirability of "moving to a broader framework for the determination of prices and incomes, one which.....includes discussion between both sides of industry, the agricultural sector and government (acting as government) on the aims and operation of economic policy". On the other hand, I think that as an economic survey it is excessively coy in its reference to the possible utility of investigating "at what stage income taxation should be extended to cover the agricultural community."

The 1973 budget in fact increased social welfare benefits, reduced local rates but raised the taxes on beer, spirits and tobacco, increased capital expenditure by 23% on 1972/73 actual, and envisaged a deficit on current account of £39 million.

Some nine months after his predecessor had written to the Government on the difficulties of financing the public capital expenditure contemplated for 1973/74, the new Minister for Finance was emitting a similar *cri de coeur*, although he had adopted the expenditure proposals in his April budget. This prompted me to write rather acidly to Mr. C.H. Murray on 12 October, 1973:

"The memorandum puts the total financing requirement this year for the Capital Budget and the current deficit at £375 million. The memorandum also indicates a gap of £56 million between this figure and projected receipts. This is a shocking hole to appear within a few months of Budget Day and is a strong reminder of the advisability of including a substantial contingencies provision in projections of financial requirements. As you well realise, the Minister is unlikely to get much sympathy from his colleagues at this stage. Indeed, insofar as the gap is due to increases in capital allocations beyond the budgetary figures, he cannot very well cry over the spilt milk; he has licked most of it up himself in the form of an extra £10 million for the ACC; £4 million for the ICC and £2 million for Shipping Finance Corporation, out of a total increase of £20 million! One hopes, nevertheless, that the memorandum may have some restraining influence and that the Minister will see to it that the figure of £100 million mentioned in para. 9 proves to be no more than a bad dream. There is such a natural tendency, when putting forward estimates, to be tight on the expenditure side and optimistic regarding resources, that Providence should assign a special Guardian Angel to strengthen the realism of budget planners. Before the budget is determined is the time that matters; when it is being reviewed is too late for anything but anxiety."

After attending the International Monetary Fund annual general meeting, which was in Nairobi that year, I spent most of October and part of November in the Cherry Orchard Hospital wrestling with a fever I had picked up in Africa. I see that, nevertheless, I wrote a short note from hospital on 19 October to Mr. C.H. Murray which explained that "what I had in mind in my earlier comments was simply this - that if the Minister for Finance does not exercise due caution in settling the budget, he is not likely to arouse any sympathy from his colleagues when he says later that he cannot see how to make ends meet. They properly regard financing as his responsibility.

As you know, I think he extended himself too far regarding both capital and current expenditure".

The difficulties associated with the financing of the Exchequer towards the end of 1973 were such that, as recorded in Chapter V11, the Central Bank agreed exceptionally to help by buying £20 million of short-term Government securities.

The expansionary policies of 1973 induced a high rate of economic growth - of the 7% order - but prices rose between end-1972 and end-1973 by the then unprecedented rate of 13% and the balance of payments deficit would have been nearly £120 million but for net EEC transfers of about £30 million. The momentum of growth, which the Central Bank was concerned to see maintained (Autumn Bulletin 1975 p.5) was, however, slowing down in the final quarter of 1978 even before the quadrupling of the price of oil completely altered not only the Irish but the world economic scene.

Mr. C.H. Murray and I attended early in December an EEC meeting in Brussels where what I described as a "Götterdämmerung" was unfolded - the grim possibilities of a reduction of GNP_x ^{growth} in the Community to a zero or negative rate, accelerated price inflation, an overall 2% to 5% increase in unemployment and major balance of payments and exchange rate problems. These were heralded as the likely consequences of the continuation throughout 1974 of the increased price of oil and a 20% shortage of oil supplies.

Against this background I wrote as follows to Mr. Murray on 5 December, 1973:

"This radically alters the prospective 1974 conditions for Ireland. Indeed, it seems to me that we face an emergency of the same kind (though hopefully, not of the same severity or duration) as that of the 1940's and that social equity, no less than economic necessity, requires that we have available to us the same range of powers and measures to cope with it. Apart from control of distribution of scarce supplies (not only of oil) we should envisage protecting ourselves against quite disproportionate inflation by statutory regulation of incomes of all kinds as well as of prices.

From the point-of-view of preparing openly for such contingencies, it is unfortunate that public consciousness of the gravity of what impends is still quite limited and doubly unfortunate that a headline for 1974/75 wage and salary increases may be set before there is a wide realisation of the irresponsibility of aggravating the coming production and employment crisis by rates of money income

increase which could make even a reduced output unsaleable. I do think, however, that every means open to the Government should be used to try to ensure a moderate wage settlement. The reduction in the community's real income occasioned by high import price increases and energy shortage cannot be compensated for in reality; so even to go through the motions of doing so by allowing money income increases in line with cost-of-living increases is in part illusory and must add to inflation. I concede the practical difficulty of doing less on the wages front than appears to "compensate" for price increases. But at least there should be strenuous efforts to avoid a faster rise in incomes than in prices, as this can only add to the troubles ahead. If, by good fortune, there is some real improvement in Ireland's GNP in 1974 it is important that it should come to us in the form of an alleviation of price inflation rather than as a further addition to our money incomes.

I should be glad if you would show this letter to the Minister. To influence expectations and attitudes he may think it well that the Government should shortly meet both trade union and industry representatives to discuss the 1974 economic prospects.

It was, I fear, not only public consciousness of the gravity of the new turn of events that was lacking: the Government's reaction was also slow and inadequate. In part, but in part only, this may be attributed to their preoccupation in the early days of December with the final phase of the Sunningdale negotiations. Mr. Murray had brought my letter of 5 December to the Minister's notice immediately and had discussed it with him on his return from Sunningdale. But, as Mr. Murray's letter to me of 18 December records:

"At that stage the National Pay Agreement discussions had virtually been completed. I recommended that Government Ministers should call a meeting with the social partners forthwith and should alert them to the grave deterioration which had taken place in the economic situation since their discussions commenced. It would be necessary to do this forthwith since the conference was likely to have a final meeting on the draft agreement within two or three days.

The Minister later informed me that he had mentioned this matter at a Government meeting and that the Government had decided against any intervention on the lines I had suggested. Ministers would, however, stress the serious uncertainties about economic prospects in any speeches they might be making e.g. on the Adjournment Debate.

Meanwhile, as you know, the conference has adopted the Third National Pay Agreement and Trade Unions will be balloting on it in the coming weeks. For our part, we are endeavouring to "quantify" the energy crisis and its likely effects on the economy. I know that the Central Bank is also doing some work in this area and we have agreed to exchange the results."

I had myself sent a manuscript letter as follows on Saturday, 15 December, to the Minister for Finance at his home:

"I have not yet got a copy of the booklet setting out the terms of the next National Wage Agreement as recommended by the Employer-Labour Conference. But if the media reports are correct which indicate increases for workers on £15 a week of 21%, on £20 a week of 17%, and somewhat diminishing annual rates of increase for the higher-paid, then this is a prescription for galloping inflation. I would think it most inadvisable for the Government to adopt a passive attitude to acceptance or rejection (as inadequate, of course!) of such terms. On the contrary, every effort should be made to introduce some realism and responsibility into the situation before it is too late.

The gravity of what would happen if pay increases of this size were sanctioned must be obvious when one remembers that we have had, in 1973, despite an exceptionally high growth rate of industrial and national production and lower pay increases than are now recommended, an unprecedented inflation rate - a 12½% increase in the consumer price index in the year to November, 1973. Next year we shall be fortunate to have any positive growth in national output; and import price increases, not only for oil but for many other materials, are likely to be higher than in 1973. One can only gasp at the acceleration of the inflation rate which will occur if, on top of this uncontrollable adversity, there are domestic pay increases of the 20% order. It is more straightforward to grapple with the problem now than to be forced to try later, by blunt fiscal and other measures, to counter, or partly neutralise, the effects, against a background of disillusionment and resentment. I would have considerable confidence in the Government being able to obtain the general support of the public for a responsible and fair approach to the present difficulties. It cannot reasonably be expected of the Government in this critical period to exert more than its best endeavours to protect the real standards of the less-well-off sections of the community.

I suggested frank Government talks with unions and employers on the economic situation in my letter to C.H. Murray following the disclosure of the EEC Commission's expectations for 1974 at the meeting in Brussels on 3/4 December. This would be a beginning."

On 18 December I put the following "confidential note" on Central Bank papers:

"I wrote the foregoing letter to the Minister for Finance on Saturday, 15 December, and it was delivered to his house by hand that evening. I had an opportunity in Brussels on Monday, 17 December, to reinforce what I said in the letter in direct conversations with the Minister. The Minister stated that he would speak in the Senate this week on the changed circumstances affecting pay questions and he referred to this intention in the course of a press conference in Brussels in which otherwise he tended to play down the seriousness of the economic outlook. I stressed to the Minister the importance of the Government appearing to exercise prudent foresight and to be taking all steps to protect the community on the basis of equitably-shared adversity. To be passive about the new National Wage Agreement proposals would be a serious abrogation of concern for the proper management of our economic affairs. Even if the first leg of the proposed Agreement were stretched to cover a year (and not six months) a settlement on this basis would still be inflationary, though much less so than the quite irrational 17 to 20 per cent. figures. In my letter I had concentrated on the inflationary aspects but the proposals would also aggravate unemployment and make it much more expensive for the Government to relieve such unemployment by public works. It was better to try to stop people getting too much pay than to move in afterwards with any form of compulsory saving through taxation. I do not know what effect my words will have; we must await the Senate speech and further developments."

Mr. Murray's letter of the same date, which I have already quoted, shows that the Government decided to let things ride. Ministerial speeches, while they stressed the seriousness of the economic outlook, confined themselves to adjuring trade unionists to abide by the terms of the new Pay Agreement. No attempt was made to have it revised. I have always regretted the Government's failure to treat the end-1973 situation as the emergency it really was. An opportunity was lost to gear ourselves to get through the critical years that followed with less unemployment and less foreign borrowing.

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Preparations for the 1974 budget, which was introduced in April, 1974 and was to cover the nine months April to December 1974, began in the late Autumn of 1973 with the submission to the Government by the Department of Finance of memoranda on the extravagance of the estimates for both current and capital expenditure. The massive increase in capital expenditure envisaged by Departments was not required to sustain satisfactory growth and would only intensify inflationary pressures. Foreign borrowing was an uncertain source of funds and involved a substantial currency exchange risk - a risk which had materialised in the recent past. Major cuts were necessary on the non-pay side to reduce the prospective current deficit of £98 million. The revenue estimate, indeed, did not allow for the possible adverse effects on the economy and on tax buoyancy of a prolonged fuel shortage.

In spite of this display of orthodoxy by the Department, I found myself writing to Mr. C.H. Murray on 14 February :

"I am appalled that serious consideration is being given to proposals involving (income) tax relief at an annual rate of £22 million at a time when, with dark clouds ahead on the economic front, (a) money incomes are likely to be rising at a most inflationary rate and (b) public expenditure is also running far ahead of an even undiminished revenue. Surely some good sense should be intruded to prevent decisions being reached which seem certain to be the opposite of what is appropriate to 1974/1975 ?"

Later that month Mr. Murray raised, at the Government's instance, the question of additional finance from the banking system to meet increased public capital expenditure. This matter is dealt with in Chapter VII.

On 8 March, 1974 I sent a manuscript note as follows to Mr. Murray:

"A short comment on what you told me yesterday about the budgetary prospects.

The expenditure totals, both current and capital, are much too high, despite the efforts made to cut them down. The current side will be further inflated by social welfare increases.

It is this excessive level, and the accelerated rate of increase, of public expenditure that causes the overall borrowing requirement from banks and foreign sources to be so inordinately high. The already announced intention to grant income tax reliefs will make it higher still.

The unprecedentedly grave problem thus created can be alleviated - it seems impossible to solve it - by a combination of further cuts in non-pay and capital expenditure and extreme caution about the scale of social welfare improvements. It is on this that attention should focus.

To make farmers liable to income tax is, I hope, a decision already taken. The question of closing some of the gap by taxing "luxuries" (beer, spirits & tobacco) should take second place to restraints and cuts in expenditure. But it cannot be excluded from consideration purely because it would raise the consumer price index by a percentage point or so: the corresponding borrowing would also be inflationary, even if it did not raise the total borrowing requirement to an impracticable level.

Inflation will never be eased if the rise in public expenditure is not kept within narrower bounds, however it is financed. An increased deficit (capital and current combined) should be reserved for economic conditions requiring, as our present situation does not, a strong expansionary impulse.

It is, as we agreed, unsatisfactory that taxes to redistribute income in favour of the needy should reckon as a basis for further income increases for the better-off and it is desirable that the "escalator clause" in future National Wage Agreements should exclude this element from the consumer price index.

The ballooning of the uncovered Exchequer borrowing requirement to the figure of over £100m. at present in prospect leaves me with the most uncomfortable feeling that effective management of our financial affairs is slipping out of our hands. I have not had this feeling so strongly ever before."

The Central Bank's comment in the Spring Bulletin, 1974 was as follows:

The recent budget accentuates the tendency for public expenditure, both current and capital, to constitute an ever-increasing proportion of GNP.

Where a budgetary stimulus is needed, it would seem preferable to provide it by way of additional borrowing for capital purposes. The recent expansion of current budget deficits is disquieting, especially because these involve the financing of current outlays by borrowing. The proportion of total borrowing which comes from the banking system and from abroad is increasing rapidly. When the public sector borrows extensively from domestic sources it tends to "crowd-out" the private sector and when such borrowing is undertaken to finance current budget outlays there is risk of a net loss to the economy of productive investment. As the public sector increases its borrowing from abroad so the debt service mounts up, representing an ever-increasing outflow of payments from the economy, payments that must sooner or later be met from extra taxation. Apart from other serious disadvantages of borrowing from abroad, such as exchange risks there is considerable insecurity involved in being dependent on foreign borrowing on a rising scale.

The point I had made in my note of 8 March was repeated in the Bank's Report for 1974:

It is unsatisfactory that taxes imposed to reduce inflationary borrowing or to redistribute income in favour of the needy should reckon as a basis for further income increases for the better-off. As part of a national commitment to control inflation it is desirable that the "escalator clause" in future national pay agreements should exclude this element from the consumer price index.

The Bank thought it well in its 1974 Report to set out its views on the appropriate reaction to the oil crisis:

There is in many countries a disposition, following the sharp raising of oil prices, to favour somewhat uncritically a counter-policy of expanding domestic demand and borrowing more abroad. This policy should be pursued cautiously as a means of gaining time for a smoother adjustment to this adverse turn in the terms of trade. It is not possible for life to go on just as before after such a major increase in energy costs. There cannot but be a real disimprovement, or at least a slower rate of improvement, in economic and social standards in oil-importing countries. More has to be produced for sale abroad to pay for the higher-priced fuel; correspondingly less is available to raise domestic living standards. The adjustment can take several forms. The most obvious and least painful is economising on unnecessary consumption of energy. Another is to produce more from existing or prospective energy sources under national control, if the relative costs make this attractive. Relief may also come from a favourable turn over the years

ahead in the terms of exchange as between industrial products and oil. Eventually, it is hoped, the exports of oil-importing countries will benefit from the spending of the billions of dollars now being hoarded by major oil-exporting countries. Prudence, apart from practical exigencies, would, however, forbid prolonged reliance, year after year, on large-scale foreign borrowing as a means of financing external deficits, particularly if what might be called the "non-oil" deficits are themselves allowed to expand. It is, unfortunately, the countries already in deficit which are worst affected by the rise in oil prices and, unless they make some adjustments, they will find it progressively more difficult to borrow heavily on terms likely to be acceptable economically and politically.

Those interests who, in an unqualified way, advocate expansion of public expenditure, foreign borrowing and bank credit in the immediate interests of economic growth and employment would do well to keep in mind that an expansionary policy can lead only to disaster if it is pursued to the point of accelerating the relative increase in domestic costs and prices by unduly straining productive capacity - of which skilled labour is an important element - and if it requires an inordinate volume of external indebtedness to finance it.

The Bank, while conceding that a neutral budget would have been inappropriate, affirmed its belief that a "less substantial borrowing requirement, achieved particularly by a lower rate of increase in current expenditure, would have been sufficiently expansionary to replace much of the purchasing power absorbed by the large oil import bill and would have carried less risk of aggravating domestic inflationary pressures."

It is also worth reproducing the general policy stance enunciated by the Bank in that Report:

The Central Bank reaffirms its support of policies directed towards the maximum sustainable growth of output and employment. The Bank is, however, unhappy about the pursuit of expansion on the necessarily unsustainable basis of a relatively rapid price inflation and a widening gap in

external payments requiring heavy foreign borrowing to finance it. The Bank is concerned, in particular, to make the point that expansionary policies could be much more effective, and would be much less dangerous, if they operated on a lower rate of increase in money incomes and prices.

The Bank had been informed at the end of May, 1974, that the budgetary provision for pay was already gravely deficient because of the conceding of "grade" claims. So massive, indeed unrealistic, were the current and capital outlays in prospect for 1975 that the Department of Finance was seeking policy directives from the Government on how the problem should be tackled - whether by way of huge increases in taxation, cutting provisions below the 1974/75 level, not proceeding with transfers of local charges to the Exchequer as promised, not paying public service pay awards, freezing the numbers of posts, making little or no ~~limited~~ social welfare or income tax concessions.

The Bank, meanwhile, was laying down the credit guidelines to be observed "so as to conform to the Government's objective of raising real national output by around 4½%, while limiting the balance-of-payments deficit to some £150 million and the rise in prices to 15 per cent or so". Credit was to be restricted to productive purposes and to be increased at no greater rate than Gross Domestic Expenditure (i.e. about 20%). Penalties were provided for any increase in gross lending as between May and November in the financial and personal categories and, except where the national interest was clearly involved, external financing through the banking system was also controlled by severe penalties.

Throughout that Summer and Autumn the Department of Finance was bombarding the Government with memoranda on the disquieting economic and budgetary prospects. The rate of inflation was accelerating and the balance of payments deficit widening. The Government was asked to exert its influence to moderate the next pay round and to restrict public expenditure. The main thrust of economic policy over the next eighteen months should be directed towards bringing domestically generated inflation under effective control.

It was not only the "grade" claims of over £8 million which were unprovided for in the 1974 current budget but a whole string of other excesses amounting in all to £28 million. Capital expenditure was also spilling over.

The Minister for Finance was trying hard to have specific maximum allocations fixed for the capital and current expenditure of the various Departments and State bodies, but the ground was slipping from under him; the size of the prospective deficit kept on growing. The Government indicated a willingness to increase the proposed non-pay allocations by almost £90 million. I wrote to him as follows on 5 September, 1974:

"I had been hoping for some good result to the efforts you have been making over recent months to pull back public expenditure from its present disaster course but I am appalled by the information given in confidence to me last evening by Mr. Murray. I find it hard to credit that the Government could be seriously contemplating budgetary dispositions involving such enormous (and even impossible) increases not only in taxation but also in foreign borrowing in order to finance additional current expenditure. I make the envisaged increase in current public expenditure in 1975 about 25 per cent. I wrote in dismay last March to Mr. Murray that effective management of our financial affairs seemed to be slipping out of our hands. As a public servant who has had reason to believe in the predominant influence on our economic development of a general public confidence founded on evidence of good management of the national economy, I am most disheartened by the prospect ahead.

To create a climate favourable to savings, investment and growth, the Government must be seen to be exercising prudent foresight and to be directing its policies to ensure that the community works up to, but within, its capacity. Its first concern should be to correct an over-stretched situation, such as we already have, rather than to push our finances, both internal and external, further into the red and cause (directly or indirectly) an even steeper rise in prices.

You referred in your memoranda to the tendency to pre-empt the next year's revenue buoyancy by giving over-generous concessions in the first year for only part of the year. Expenditure budgets, as your records also show, are much more vulnerable to underestimation in a period of advanced inflation and universally disturbed economic conditions. When the known prospects are bad, there is an understandable but noxious temptation not to budget adequately for inevitable contingencies and even to make large arithmetical cuts (e.g. in pay provisions) which stand little or no chance of being realised.

The contingencies with which we must reckon, and for which we should keep something in reserve, are wider in scope and more serious than in normal times. They obviously include abnormal security and other risks arising from the worsening situation in Northern Ireland. Farming and building already present inescapable problems.

I cannot but regret the adoption (by your predecessor in office) of the practice of deliberately incurring a substantial deficit on the current account of the budget. By some this was heralded as a belated discovery of Keynes but competent economists will confirm what you said in your memorandum of 22 July last to the Government, namely, that the distinction between capital and non-capital expenditure is neither decisive nor relevant from a policy point of view in present circumstances. They would go further and say that what matters, from the expansionary standpoint, is the total borrowing requirement. My view is that it would not only be possible, but would make more sense, to look after economic expansion, so far as may be necessary, by varying the amount of borrowing for public capital purposes. It must cause many an ordinary citizen the greatest concern to see debt being incurred on a large scale, including above all foreign debt, to meet current everyday needs.

I do hope, therefore, that you will succeed in persuading the Government to adopt reasonable budgetary decisions, lying within the national capacity and tending to abate rather than aggravate the alarming rate of inflation, as reflected in prices and external deficits, which we are now experiencing.

While your immediate pre-occupation may be with budgetary matters it is important to remember that the course of money incomes exerts a very strong influence on public expenditure trends, apart from its broader economic effects on production costs, competitiveness and consumer expenditure. Pay and pensions now represent,

I understand, about half of current public expenditure. It is, therefore, vital that action to contain public expenditure, with a view to reducing inflationary pressures, be backed up by arrangements to reduce the rate of growth of money incomes. If this flank is not covered, the prospects could be even worse than your own memoranda indicate. As a community we are at present living vastly beyond our means, running an external deficit of around £250 million per annum or ever more, but getting little value for this, and the associated foreign borrowing, in terms of real economic growth.

The plain fact is that the total resources we are using, for consumption and investment, are now more than we can nationally afford and this imbalance will get worse if we keep giving ourselves inordinate money income increases, the effect of which will be to push up imports and make exports less competitive, so widening still further the balance-of-payments gap, until it becomes absolutely impossible to finance. Profligate small countries can expect only short shrift from foreign lenders. Even Italy has had to suffer in prestige and real independence by becoming internationally bankrupt.

I strongly suggest, therefore, that the consideration of Government policy regarding incomes be completed soon, so that sustained and effective action can be taken before events take control, as they did last December. The Government ought not allow itself again to be edged into the position of having to call for strict and general observance of a pay settlement which was obviously excessive and contrary to the national interest. Expansionary policies directed towards economic growth, high employment and social advance depend directly on there being a more moderate rate of increase in money incomes. There is simply no room for any expansionary leverage, given existing price and external deficit conditions, if money incomes rise in future at the rate your Department apprehends. It is only by trying in good time to propagate a general understanding of this truth that there is any chance of establishing reasonable expectations and attitudes. I suggested last December, and I still believe, that for an emergency period it would be nationally advantageous and socially equitable to confine policy to that of maintaining real incomes in the non-agricultural sector. This could be secured by an agreed (or, if

necessary, statutorily enforced) limitation of quarterly income increases by reference to the previous quarter's rise in the consumer price index. This policy should not apply solely to employee incomes (wages and salaries) but also to profit margins and distributions, rents and fees and, indeed, social benefits. It would not mean that, so far as there was real growth of the economy, this would remain undistributed or accrue, say, to the makers of profits; it would be absorbed partly by some unavoidable "drift" but, more desirably, by increased employment and an accelerated abatement of the rate of price increase. The underlying notion of protection of real standards, and equitable sharing of difficulties, should help towards acceptance of such arrangements for a finite period.

As mentioned in the Bank's Annual Report (page 10), there are grounds, on certain assumptions, for expecting an income indexation system, such as I have just described, to bring about a reduction in the rate of inflation to less than 7% for 1976. The earlier it is introduced as (for a time) the sole regulator of money income increases, the better. I hope serious consideration will be given to this idea.

In one of your memoranda there is a reference to the possible contractionary effect on employment of a slowing-down of the rate of increase in public expenditure. Even if there were some prospect of such a slowing-down, might I remind you of the relevance of the points repeated in the Bank's last Report. Having re-affirmed our support for policies directed towards the maximum sustainable growth of output and employment we said :

"The Bank is, however, unhappy about the pursuit of expansion on the necessarily unsustainable basis of a relatively rapid price inflation and a widening gap in external payments requiring heavy foreign borrowing to finance it. The Bank is concerned, in particular, to make the point that expansionary policies could be much more effective, and would be much less dangerous, if they operated on a lower rate of increase in money incomes and prices."

The Minister replied on 17 September, saying that he had carefully considered my views and had brought them to the attention of his colleagues.

Obviously, however, the cause of economy was foundering. A critical point in Government discussions was reached on 24 September when I received an unprecedented summons. I had on a few occasions in my Finance career been called to Government or Cabinet Committee meetings but never before as Governor of the Central Bank. My contemporary manuscript note reads :

"At 1.30 p.m. on Tuesday, 24 Sept. the Minister for Finance phoned me at home asking me to help him by attending the Government meeting when it resumed at 2.30 p.m. I had a short word with the Minister before being called down to the Council Chamber about 3 p.m. The Minister told me that the budgetary discussions, despite his efforts, were drifting towards a lower (halved) tax increase, with higher expenditure and much larger external borrowing.

When I joined the meeting, the Taoiseach referred to my letter to the Minister for Finance of 5 September, which had been circulated to the Government, and asked for my views on the economic situation, with particular reference to the propriety and practicality of increased foreign borrowing to tide over a difficult, but hopefully temporary, phase and avoid serious loss of employment.

I began by explaining that I was giving sincere personal views based on my experience and training, not just voicing some partisan or "Central Bank" viewpoint. The Board had not seen my letter, because it contained confidential budgetary indications, but I had no doubt that I would be supported in what I said, since it was not out of line with the published views of the Bank in their Annual Report and earlier.

I then elaborated on what I had said in my letter, stressing (1) that the issue was not one of whether or how to meet public expenditure, but rather of how much expenditure there ought to be; (2) the present rate of inflation was itself the greatest threat to employment, since spending more against the background of accelerating price inflation and a 30% money income increase prospect could only result in an external deficit beyond any hope of financing and therefore, in a massive cut back suddenly in consumption, investment and employment;

(3) the critical policy requirement was control of wages, salaries etc. by an indexing system, which would bring relief both to the finances of the State (50% of current public expenditure being pay) and to those of the national economy, enabling jobs to be safeguarded and increased for less new outlay and on a more realistic level of foreign borrowing. We had at present an over-stretched position.

Points raised by Ministers included:

- (a) the possibility of an easing off in a year or two of imported price inflation according as basic commodity prices fall (I pointed out that, even if this happened as I hoped it would, we would still have the adverse trade effects of the increase in oil prices and the adverse cost effects of the alarming rate of money income increase, so adjustment was inevitable and could not justifiably be ignored in an all-out borrowing policy).
- (b) the possibility of borrowing in 1975 considerably more than in 1974 by recourse to international institutions, reserves etc. (I disclaimed any expertise in this field, on which the Dept. of Finance would be better informed, but expressed doubt as to possibility of raising abroad, except every two or three years, a sum of the order of the £84m. obtained from a syndicate of bankers in 1974. The foreign reserves were just average by industrial country standards and would need to be held to meet temporary shortfalls and on the basis of replenishment in a reasonably short period. The oil facility in the IMF was about \$80 million, say £30 million, in Ireland's case and our quota was £56 million. This, if drawn, would have to be repaid within 5 years and our obtaining it would be subject to conformity with economic policy guidelines expressed in a "letter of intent". However, this interference with sovereignty could be stomached more readily from an international body than from an individual foreign Government. Italy's real political independence had suffered by her having to accept a massive loan from Germany. It would be unsafe to bank on borrowing more abroad in 1975 than in 1974; the opposite might well be the case.)
- (c) the question of separating the Irish £ from the pound sterling.
(I pointed out that only revaluation would have any virtue, but could impose undue strain on exports, on our competitiveness and on the balance of payments, unless price and, in particular, labour cost trends were thereby improved. The subject was under constant examination and there would be no delay in reporting to the M/F if, par miracle, a move towards alignment with US \$ or European snake seemed nationally advantageous).

In the course of exchanges with Ministers, I said that too much money had been given away over the past eighteen months in tax reliefs and social improvements. We could not afford all we were trying to do at present. I would not favour cutting back on social welfare but would wish to maintain existing real standards in this and the Health fields. Some tax increases (e.g. on the "old reliables") would have been acceptable last Spring and would have made some contribution to lowering the unjustifiable current account deficit and the disquieting level of foreign borrowing.

The interview concluded about 4.15 p.m."

The Government approved various increased allocations and the situation at the end of October was that a current budget deficit in 1975 of £88 million and a residual (mainly foreign) borrowing figure, inclusive of the current budget deficit, of £209 million were projected. The petrol tax was increased to induce economy in the use of oil and, at the same time, to raise revenue. My note of a conversation with Mr. C.H. Murray in Brussels on 19 December 1974 reads:

"I have been arguing all along against so large an increase in current expenditure as must involve a heavy addition either to borrowing or taxation. Such expansionary stimulus as can safely be imparted in 1975 (and this depends on moderation of income increases) should, in my view, come preferably from the capital side.

Following the recent tax increase on petrol - which will help to reduce the prospective current deficit - I would not like to see the need for any further substantial tax increases. An increase in VAT could only cause an even sharper rise in prices than that already expected.

If, however, some additional taxation is needed to counteract excessive current expenditure increases, this should perhaps take the form of adjustments to the "old reliables", which may be least harmful in their overall economic effects."

On 20 December I sent Mr. Murray a further letter commenting on a memorandum on "Economic and Social Policies 1974-78" which he had sent me on 18 December. I reproduce it in full because the opening part reveals me in an unusual role and the remainder is a succinct statement of views on planning:

"May one, often accused in his Central Bank capacity of a propensity to utter dire forebodings, suggest that the author of the memorandum has all too effectively painted an unrelieved picture of gloom. The immediate prospects in the western world and Japan are admittedly unpleasant but one must not, when looking ahead for three or four years, overlook the normative character of the grim warnings now being issued by international bodies like the EEC and OECD: these are intended to induce counteractive policy measures in the major countries and, reinforcing domestic pressures, are already having some effect - in the US and Germany, for instance. There are even hopes of a widespread upturn in economic activity as early as the second half of 1975. It should be remembered, too, that the volume of world trade is still expected to increase, although at a much lower rate than in the recent past. Besides, one must guard against a cumulative despair: if, in fact, there is going to be a severe world-wide recession, it seems odd to expect at the same time that import prices will go on increasing (indeed, that a 15% rate of increase would be "moderate"); and, if some basic commodities are in finite supply, it would be unwise, on past experience to underrate the capacity of strained consumers to find or create alternatives.

These are only some qualifications to an assessment which regrettably is in many respects difficult to quarrel with.

My main purpose in writing to you is to stress once again a point I have made several times in the past two years: that while a unique and purportedly comprehensive plan or programme may never again be appropriate, there is a need (all the greater in a period of instability and strain) to relate Government policies and actions to a plausible assessment of resource availability and use over a few years ahead, not just on a month by month or year by year basis. This assessment should rest on a set of, say, three macro-economic projections based on somewhat different, but not evidently unreasonable, assumptions; and it should be adjusted according as events show which set of projections corresponds most closely to reality.

What I am saying is that programmes for economic growth are one thing and an adjustable three or four year framework of projections as guides to efficient policy choices are another. The latter remain, in my view, indispensable instruments of good administration.

I am not clear as to the function in all this of the proposed 5 - year forecast of "public policies and related expenditure programmes". In para. 15 it is stated that "these will form the essential core of a national economic plan".

I hope this does not mean that a national economic programme will have to be adapted to, or built around, whatever may emerge as public expenditure desiderata. My difficulty is partly recognised in the bracketed sentence in para. 13, namely, "Since Exchequer resources are in large part a function of national resources, it would, of course, be necessary to adopt various working hypotheses of economic growth for the purpose of public expenditure forecasts". The inclusion of "public policies" in the expenditure forecasts seems to endanger the principle of assessing maximum resource availability first (on various assumptions) and then deciding how, and in what proportions, public and private spending can best contribute to, and be accommodated within, that availability. We must surely guard against letting public policy and expenditure proposals take over the role of a plan; this would be to reverse the appropriate procedure.

The approach to projecting public expenditure over 1974/78 seems to imply that additional resources would be allocated over the period to the public sector. This does not seem to be in line with the Estimates Circular which provides for no real growth in public expenditure over the period 1976 to 1979."

With the turn of the year, the terms on which a new pay round might be negotiated became of critical importance. The Government had made an effort to generate a sense of the need for restraint by publishing a White Paper on National Partnership and holding talks with the Irish Congress of Trade Unions and other interest groups. The Central Bank had already published in its Spring Bulletin a special article on "Inflation and Money Incomes" and had followed this in its Autumn Bulletin with warnings on the inevitability of a trade-off between employment and incomes:

"The situation is already one of unprecedented strain on financial resources and if this strain is further increased a harsh choice will be enforced: constantly rising incomes can be insisted upon only at the expense of employment"

I did not feel that the Government's approach was either forceful or sustained to an adequate degree, as appears from the following letter to Mr. Murray on 2 January, 1975:

"I have always favoured a Government initiative to set the tone for such negotiations well before the ICTU (or individual unions) do so. Again this year an over-cautious stance may have let the opportunity

slip. If Ministerial talks with the ICTU and publication of the White Paper have had little impact, perhaps this is due in part to their not having been followed up intensively behind the scenes.

While, as you know, I support the indexing proposals in the memorandum it would be politic (and true) to present these as being more generous than present economic prospects justify. There is a good deal of evidence of deterioration in the world outlook in recent months. At the same time as I was reading the memorandum I had on my table the confidential IMF "World Economic Outlook - General Survey" dated 24 December, 1974. This document contains the following significant passages:

"Some press reports called the 1974 Annual Report the gloomiest in the Fund's history. Be that as it may, the picture of the world economy that it provided at mid-1974 has become even grimmer during recent months.....

The evidence that has accumulated in the past few months makes the prospects for international output and prices even worse than they were at the time of the Annual Meeting. It points up the serious and painful dilemma faced by many member countries in their endeavour to counter recessionary tendencies while continuing to combat inflation. Walking this tightrope is all the more difficult for national authorities because of the deterioration in business and consumer confidence that has occurred and because of the instability arising from the unprecedented large deficits in the current account positions of oil importing countries.....

As might be expected, the prevailing "stagflation" is marked by a struggle of various income groups to maintain their relative positions. It should be stressed that, under these conditions, an effective use of some form of incomes policy, whether formal or informal, could be of considerable help to the national authorities in dealing with the growth/inflation dilemma and that, correspondingly, the lack of such a policy approach would make for a worse economic outcome".

It is of interest that the indexing idea had been sponsored by the Central Bank and that my letter was accompanied by a "strictly personal" manuscript note to Mr. Murray which read:

"A propos of the second para. of the attd. letter, I should tell you that, at the Institute of Bankers dinner on 16 Nov., the M/F, speaking to a few participants at the interval, said that income indexing was killed because it had been advocated by the Central Bank. I protested that the Government had had ample time to make it their own, having in mind that I wrote privately to Finance about it in Dec. '73 and January '74, long before it appeared in our Annual Report in July '74 as an incidental recommendation."

The year 1974 had proved to be a year, in the words of the National Economic and Social Council, "of very weak growth and increasing unemployment". The money incomes of farmers fell by about 15% but those of non-agricultural workers rose by almost 20%. Consumer prices at end - 1974 were 20% higher than a year earlier, the average inflation rate for the year being 17%. The balance of payments deficit on current account exceeded £300 million. Unemployment which averaged about 72,000 for the year had been rising steadily in the second half and exceeded 100,000 by early 1975. The economy had suffered the combined effects of the greatly increased cost of oil and raw materials, the depressed world market for beef, a downturn in output and high wage and salary increases (Central Bank Report, 1975).

.....oO.....

The economic situation at the outset of 1975, with little improvement in sight, called clearly for a measure of fiscal stimulus to sustain employment, provided, as the Central Bank constantly urged, incomes restraint were observed and Government borrowing were reserved predominantly for capital purposes. The Bank's preference was for curbing current expenditure increases and raising extra revenue by direct taxation rather than by relying altogether on indirect taxation, with its immediate impact on prices.

The 1975 budget, presented to Dáil Eireann on 15 January, 1975, increased taxation by a net £35 million, mostly on the "old reliables", in order to reduce the current deficit to £125 million. The amount to be borrowed abroad was said to be "close on £225 million". Income tax and company tax reliefs were granted, the top rate of income tax being cut from 80% to 70% to coincide with the introduction of the new wealth tax, and social welfare benefits were improved by rather more than 20%. The Minister for Finance described the budget as "carefully expansionary". The increase projected in public expenditure was of the order of 25% as compared with the previous year. Public expenditure was now 45% of GNP, as compared with 28% in 1960.

By March, 1975, however, the outlook for 1975 was of excesses totalling over £100 million in current and capital outlay as compared with the budgetary provisions, and a greatly increased foreign borrowing requirement (£340 million). The Department of Finance was calling the Government's attention to the urgent need to strengthen control over public expenditure. At the same time the Department - no doubt responding to Ministerial interest prompted by continuing debate in the media and the putting down of a motion in the Senate - was submitting to the Government a memorandum on the "Exchange Rate of the Irish Pound". The memorandum rehearsed, from a neutral standpoint, the case for and against both revaluation and devaluation. Interest in the possibility of a change in the parity relationship with sterling was stimulated by expectations of continuing depreciation of sterling in relation to the dollar and deutschemark and it was revaluation, not devaluation, which was contemplated for the Irish pound, despite all the evident weaknesses of the Irish financial situation.

The Central Bank judged it apposite to deal with this subject in its 1975 Report (presented in April, 1975):

"Some hold the belief, which tends to paralyse action, that the Irish rate of inflation is automatically determined by external factors because of our open economy and the fixed parity relationship of the Irish pound to the pound sterling. Admittedly, this exchange relationship exposes Ireland to much the same external price influences over a wide field and sets up a long-term convergent tendency of the rate of inflation in the two countries. It does not, however, prevent Ireland from inflating more rapidly than Britain: it remains within our discretion to add domestically to the effects transmitted through the exchange rate link. Because of a faster rise in money incomes here, or a more expansionary fiscal policy, Irish costs and prices can be pressed upwards unduly and the Irish balance-of-payments deficit can be enlarged. In such circumstances, in order to protect the exchange rate, it can become necessary to correct the excessively strong domestic demand and it is inevitable that measures to this end will adversely affect employment. It is also possible - and obviously much more desirable - by less inflationary domestic policies to secure a competitive advantage for a widening range of Irish products, thus enlarging sales and employment opportunities and strengthening the external balance. Only in this way, indeed, could a sound base be established for a move to a higher rate of exchange, if that were desired.

The freer discussion of these matters which has been encouraged in recent years has promoted a revival in some quarters of the often emotive, and rarely well-defined, notion of "breaking the link with sterling". It is important that it be understood that a change in an exchange rate is not a magic wand which will make domestic pressures and difficulties disappear. If any change in the rate were to be made - and only an upward one has any attraction as a means of reducing imported inflation - it would have to be founded on a virtual certainty that Ireland could establish and maintain cost and price trends lower than those in Britain. The normal aim is to maintain an exchange rate which, consistent with a satisfactory level of domestic activity, will give the best return, in terms of command over imports, for a high and rising volume of sales to foreigners of domestic products and services. Devaluation would depreciate the external value of national productive effort, making it necessary to export more merely to maintain the same volume of imports. Revaluation, on the other hand, would be an attempt to achieve the opposite effect. It could not be contemplated without reasonable assurance that the balance of payments would not be gravely worsened in the short-term by the trade effects of the change, or be upset later by adverse capital flows. It could not succeed unless the resultant cheapening of imports led to a sustained moderation of money income expectations and, therefore, of domestic cost trends, and thus made possible the expansion of exports despite the effective tax which

a revaluation would impose upon them. Home producers would need the assistance of lower cost trends in meeting competition from cheaper imports. The fact is that there is no real alternative to better ordering of our domestic affairs, expressed in more moderate trends in money incomes, public expenditure and borrowing, if it is desired to lower the rate of inflation, raise the status of the Irish currency, and earn higher external returns for Irish goods and services.

It may be pointed out, moreover, that the link with sterling is not broken simply by fixing a new relationship with sterling but only by linking the exchange value of the Irish pound to some other currency or group of currencies. "Free" floating of a minor currency is not a practical proposition.

The foregoing remarks are made in the hope of clearing away some of the misconceptions which surround the subject of the exchange rate. It is understandable that there should be misgiving about the erosion of the external value of the Irish pound but it is not desirable that false hopes be entertained as to the practicality or durability of any upward exchange rate change which would not be sustained by a basic improvement in the factors affecting domestic production costs and prices. As things are, the conditions for a revaluation are not met: the position is as it was in March, 1974, when the Minister for Finance indicated that, on balance, the sterling parity relationship still remained appropriate.

A note I made at the time reads:

When we were at the Interim Cte. meeting in Paris on Tuesday 10 June the M/F gave me an outline of what was then proposed.

I argued strongly (1) for seeking an element of pause on the incomes side, (2) for dropping the idea of eventual repayment of the 10% income-tax surcharge, and (3) particularly for ensuring that the incomes concessions were delivered before the price reductions via subsidies and tax remissions were granted. I said that I saw no reason why the Government's quid pro quo should not be published in advance as proposals, so as to lever up the incomes response. Budgetary secrecy was an irrelevance in this context.

I also spoke on the same lines to Mr. C.H. Murray when he discussed the proposals in greater detail with me on Wednesday, 18 June.

I found both the Minister and Mr. Murray, to my regret, unreceptive of my strong representations on (1) and (3). Apparently it was only on (2) I made any impact (and even there other arguments may have prevailed, rather than mine).

Not only was the 1975 budget already "bust" but the forecasts for 1976 were even more alarming, with a current deficit of some £475 million looming up and total residual (mainly foreign) borrowing estimated at about £750 million. The longer-term outlook to 1979 was no less grim for the economy and the public finances. Inflation (17% in 1974 and possibly 25% for 1975) was gathering pace - it was already twice the European average and, as the Department of Finance reported to the Government in May, "next year, on present trends, it could easily be three times that average. Unless this is swiftly reduced, the economic prospects will include mass unemployment, the resumption of large-scale emigration and intolerable living costs at home." The interesting point was made that higher unemployment benefit and, more particularly pay-related benefit had greatly reduced in the short-term the financial hazards of unemployment. Since the normal forces were not fully effective in adjusting pay settlements to competitive realities, a Government initiative was needed in the area of incomes policy. Abatement of inflation also acquired new approaches in the areas of Government expenditure and extension of the tax base.

The 1975 National Pay Agreement linked incomes to prices on a quarterly basis within certain limits. The first quarterly increase on 1 April had been 8% including the 3% price effect of the tax increases in the January budget. A minimum increase of 4% was provided for in each of the three subsequent quarters and if, over the year, the price index rose by more than 23% there was provision for further negotiated increases up to a further 3%. Coming on top of the 1974 Agreement, the prospect for 1975 as a whole was an incomes increase of over 31%. A former President of the ICTU described the 1975 Agreement as a "dizzying arrangement in highly inflationary times". * The National Economic and Social Council in June, viewing the prospects in the light of the 1975 Pay Agreement, foresaw a fall in national output of 1% to 2%, a further rise in unemployment of 20,000 to 30,000 during the year, a public sector borrowing requirement "much larger than expected at the time of the budget and which may be difficult to finance", a considerably lower current external deficit because of the fall in demand and production, and "inequality and inequity in the distribution of job security and rewards". The Council advocated modification of the detailed terms of the Pay Agreement, in particular no payments under Phase II, to be followed by measures to cut prices, indexation of pay to prices thereafter, limitations on dividends and professional fees, a 10% surcharge on personal income tax liabilities in the 35% and higher bands, higher taxation of larger, more expensive cars, an increase of £50 million in public capital expenditure, improved depreciation allowances, and regulation

* Dr. Charles McCarthy, Administration, Spring 1977 Page 123.

of imports of textiles, clothing and footwear.*

The Central Bank had been offering similar advice. In particular, it had been stressing the need for some element of pause in the modification of the Pay Agreement. What the Bank had in mind was that the second quarter's increase should be deferred or given up, as the NESC also desired. Without this July increase, earnings in 1975 were already set to rise in line with prices.

The Government decided to introduce a supplementary budget which would combine an income-tax surcharge (which it was originally intended should be later repaid) with food, fuel and transportation subsidies and cuts in VAT aimed at reducing the price index by some 4 per cent. In return, the Government would ask for a "scaling down" of the Pay Agreement. What was to be sought however, was to affect only the third phase, due on 1 October. The second phase - a minimum of 4% on 1 July - would not be interfered with. The proposal, in effect was that no minimum would apply to the 1 October increase; this and subsequent increases would be strictly in line with price index changes, as moderated by the budgetary measures.

The Minister's financial statement on 26 June, 1975 expressed disappointment at the delay in world recovery. The recession was deeper and more prolonged than anyone had foreseen. Regrettably, the precepts in the White Paper on National Partnership had not been taken fully to heart. "It is now clear that the current national pay agreement gives increases in pay, including increases reflecting taxes on alcoholic drink and tobacco, which cannot be paid in present economic circumstances without doing serious economic and social damage." Real incomes were being raised substantially at a time of stagnant or reduced national output. In 1975 external sources would contribute less than 20 per cent of Irish inflation - "the rest of the wound is self-inflicted". The Government would not allow any further special pay increases or improvements in the civil service. On the question of breaking the link with sterling, "whatever advantages there might be could not be attained unless we first of all effectively tackled the current malaise of domestic inflation". Advocates of revaluation were reminded that "for some years now, our inflation rate has been faster than the British rate".

The financial effect of the budget was to enlarge the current deficit from £116 million to £242 million and to increase the residual borrowing requirement by 45 per cent to at least £375 million. Much of the contact between the Bank and the Department that Autumn was about Exchequer financing and the part the Bank might play in it (see Chapter VII).

* Report on Inflation - NESC No. 9, Prl. 4576 June 1975

In the Summer Bulletin, however, the Bank commented on the absence of an element of pause in the modification sought in the Pay Agreement:

"It would have been preferable if trade union acquiescence in such an element had been sought and a greater and more certain degree of restraint in money incomes arranged as a prior condition of the budgetary measures announced on 26 June. These measures will operate in the right direction but the weakness on the incomes side means that the whole arrangement is less effective than the economic situation demands".

On other budgetary measures, the Bulletin commented:

"The special measures for housing (of which bank finance is the most important) could provide some thousands of jobs by mid-1976. The new employment premia.....could add to this".

"The Bank, however, warned that without a real element of pause or further slowing down in money income increases, improvements on the employment front will not be lasting."

What happened, in fact, was that the Employer/Labour Conference eventually accepted the Government's proposals; the consumer price index in the third quarter of the Agreement fell by 0.8% and thus justified no increase for that quarter; while in the final phase, the first quarter of 1976, the increase in the price index and in pay was 2.8%. As the Bank's Autumn Bulletin recorded, wage rates increased much more than total wages and salaries because there had been a substantial drop in employment and in hours worked, associated with a reduction of about 3% in national output. This bore out the NESC warning of a substantial "shake out" of labour in 1975. The consumer price index benefitted from a lessening of imported inflation as well as from the new domestic subsidies and the year to year increase for the third quarter of 1975 was 19 per cent as against 24/25 per cent for the two previous quarters.

In the second half of 1975 the Department of Finance was keeping up the forceful pressure it had been exerting on the Government for some time to bring the public finances under control. If there is less correspondence to note between the Bank and the Department on this subject, the reason is evident: it would be superfluous to express accord in principle and niggling to criticise in detail.

I had told the Minister for Finance in confidence in March, 1975, of my intention to retire on completion of my term of office as Governor on 29 February, 1976. We had agreed that an announcement would be made in the Autumn. The Minister received me on 2 October and informed me of his intention to recommend the Government to advise the President to appoint Mr. C.H. Murray as my successor. When Mr. Murray joined us and I had congratulated him on his proposed translation, the three of us (as my note records) sat together discussing other matters:

"I thought it well to say that the real reason I wished to relinquish the office was that I felt that if I were to accept reappointment this would in some way compromise my critical independence and could be interpreted as a condonation of policies I considered to be wrong.

The Minister was concerned that it should not be thought that I was leaving because of some disagreement with the Government. I agreed that there was no personal, special or new cause of disagreement. The Central Bank's disapproval of certain trends and developments of recent years had already been made quite clear in private and in public. I supported these criticisms and would continue to make them. Otherwise I would try to keep my head down in the coming weeks and not be drawn into any special interviews or discussions. I had, of course, to reserve my freedom of comment after 29 February next.

I also took advantage of the occasion to mention the desirability of more regular consultation between the Governor of the Central Bank and the Minister for Finance. This had been intended when I came to the Bank and I understood very well the difficulties involved in arranging periodic meetings. At the same time it was undesirable that contacts should be made only when there was a crisis or according as opportunity offered during visits abroad.

I said that the position of the Central Bank was an uncomfortable and frustrating one. Some people thought our duty required us to dig in our heels and thwart Government policies, if we considered them to be wrong. My personal position - which most if not all of the present Board shared - was that our principal obligation was to give appropriate, and forceful, advice on economic and financial policy before it was decided; to criticise policy decisions, both in private to the Minister for Finance and in our publications, if we thought them unwise; but to acknowledge that monetary policy was part of general economic policy, which it was the Government's democratic right to determine, and not to feel any obligation, or even entitlement,

to take counter-action. If our advice was constantly set aside or ignored, and our disagreement with policy became acute, the only course left, in my view, was to resign.

The Minister expressed some hope that the response of the trade unions to recent Government pressure on the incomes front reflected a growing recognition of the need for restraint. I recalled that I had argued with the Minister in Paris in June that he should try for more from the unions (especially a pay pause) and that he should have made introduction of the Government package conditional on the prior acceptance by the unions of adequate pay restraint. The Minister said that this was not possible if only because of the time factor and I could merely indicate that I could not accept this. I went on to say that I thought Governments tended to err in not recognising the common sense of the ordinary public and in allowing too much influence to pressure groups..."

I should add that my note also contained the following paragraphs:

Lest the above summary should suggest otherwise, I would like to make it clear that our conversation was conducted in an atmosphere of complete cordiality and understanding. I have tended to concentrate, of course, on the points which I made myself.

When I met the Minister in his office on the morning of Wednesday, 15th October, after he had confirmed the Government's decision, (i.e. about Mr. Murray's appointment), I urged him to use more "muscle" on his colleagues in Government with a view to better management of the public finances.

In November the question of the approach to incomes in 1976 was raised by the Department of Finance with the Government. The Department's definition of restraint was "holding the rate of increase in aggregate non-agricultural incomes below the rate of inflation". The objective was to "provide the basis for a sustained expansion of exports and a return to significant rates of growth in 1977 and later years". It was pointed out that full indexation would lead to a further deterioration in our competitive position. The options of a pay freeze, a pay pause and an increase not related to the rise in the consumer price index were discussed, a preference being expressed for the first, though its practicability was doubted. The Government eventually did achieve, through the Working Party on the Economy (representing Unions, Employers and Government), a two-month pause after the termination of the 1975 Agreement (March, 1976) to be followed by an increase of 3% plus £2 a week, subject to a minimum increase of £3 and a maximum increase of £5 a week, the agreement to last for a further five months (i.e. to October, 1976).

Early in January, 1976, the Government was also reviewing, at the instance of the Department of Finance, the management of the economy up to 1980 under such heads

as population prospects, employment policy, public expenditure and resources, balance of payments, incomes and prices, regional policy and development of natural resources. The Department favoured the preparation in stages of a four year programme for the years 1976 - 80. When a Green Paper had been drawn up and published embodying analysis and discussion of options, there would be consultation with the "social partners" in the light of which a Final Draft programme would be prepared for Government approval.

These moves towards moderation of the rate of income increase and towards a resumption of planning were, of course, of special interest to the Central Bank. The Bank had already welcomed in its Summer Bulletin the Government's intention, expressed in the June Budget, of moving towards medium-term assessments of how a sustainable rate of economic and social advance could be combined with a reduction in inflation. Earlier, in its Report (April 1975), the Bank had repeated the call it had often made before for a "flexible form of medium-term planning with full involvement of the major economic interests". The need for better economic management was being "accentuated by the rising trend in population and the accompanying increase in demand for jobs, houses and other social improvements." The Report had gone on to say:

The Governor suggested last November that "we should try to shape our present actions and policies in the light of reasonable projections of what the next few years may hold as regards the availability of resources, the conditions on which our productive potential can be maximised, and the pattern of the community's wishes concerning the use of resources". Uncertainties are always present but they are a reason for trying to look ahead, rather than a justification for not doing so. One of the most worrying questions for Ireland, whether the United Kingdom will stay in the EEC, will shortly be resolved but other uncertainties will persist. There would be merit in making several projections of Irish economic prospects based on different but not unreasonable assumptions, and then adjusting the course of the economy according as events may or may not validate the assumptions. No single, comprehensive, specific plan seems appropriate to present circumstances and prospects, but even tentative formulations of what the future may hold, and how we can most advantageously adapt to it, would help towards a consistent orientation of policies and actions in the right direction. The Bank has for some time viewed the consultative processes which should be associated with the tracing of possible paths towards higher national productivity and equitable

use of national resources as a means of assuring a steadier evolution of real incomes and community standards. It can scarcely be contested that the course of personal incomes and public expenditure urgently needs to be better ordered in the interests of national progress. The prospects of a more favourable external environment as 1975 advances both facilitate and compel improvements on the domestic front.

On 9 January, 1976, I sent the Minister for Finance some paragraphs which the Board of the Bank had approved for inclusion in the Winter Bulletin, to be published towards the end of the month. This action was taken so that the Minister could have the Bank's advice before taking his final budgetary decisions. I commended this note to the Minister for his consideration "as it is, in effect, a summary of the Bank's advice and criticism in relation to current economic and financial trends. It is also, in a sense, my "envoi" as Governor." Because it had this quality, I reproduce it here in full:

"The economic development which Ireland needs to provide a growing labour force with jobs and a rising population with acceptable living standards depends primarily on export capacity. Trends in productivity and labour costs must be such as to enable Irish goods and services to be sold on an increasing scale in foreign markets. In a competitive free trade environment, they must also be such that Irish products, in terms of price and quality, will be recognised as giving better value in the home market. The exchange rate should be high enough to secure the best sustainable return, in terms of external purchasing power, for Irish productive effort. Foreign borrowing should be undertaken only with discretion and in order to supplement the investment resources yielded by a high level of current domestic savings. Real incomes can over time rise only in line with real economic growth; attempts to secure more than this by way of inordinate increases in money incomes merely add to production costs, damage competitiveness and cause unemployment. To give policy-making perspective and consistency, a flexible form of medium-term planning, with full involvement of the major economic interests, is desirable. The course of public expenditure as well as of personal incomes needs to be well ordered in the interests of national progress.

Present realities are at variance with these principles. In 1975, for the first time in many years, there was a fall in national output, employment declined, unemployment rose to nearly 10 per cent of the workforce. Nevertheless, the aggregate money income of non-agricultural employees rose by 23 per cent, that of public sector employees by almost 40 per cent.

Profits fell again in real terms, thus reducing industry's capacity even to maintain existing productive capital. The community as a whole consumed an abnormally high proportion of its current produce, setting so much less aside for new investment. For some years, foreign borrowing, apart from its contribution to external reserves, has given greater support to consumption than investment. The rise in unit costs of production because of the general decline in output has been accentuated by the relatively high rate of increase in Irish wages and salaries. The rate of inflation - 11 per cent. on average in 1973, 17 per cent. in 1974 and 21 per cent. in 1975 - has been at or near the top of the European scale. Industrial exports have contracted in volume, while imports of finished consumer goods have been displacing home products on the domestic market. Even the steep depreciation of the external value of the Irish pound in line with sterling has not assured continued competitiveness. The public finances have been disrupted by the particularly fast rate of increase in public sector pay and debt service charges, and by the undertaking of commitments for which the public, by insisting on compensation for tax increases, have shown their unwillingness to pay. New public sector borrowing, for current and capital purposes, has soared from £199 million in 1972/73 to £385 million in 1974 (9 months) and £733 million in 1975. There has been no medium-term plan as a policy framework in recent years but the Government have announced their intention of filling this gap shortly.

In part, these unhappy circumstances are due to external factors, in particular to the adverse swing in the terms of trade, and the general accentuation of inflation, caused by the quadrupling of oil prices at the end of 1973. Although it was recognised that the process of adjustment should be eased by concerted action to sustain world demand, a fall of some 10 per cent. in the volume of world trade has occurred. This deficiency in international co-operation has induced resort to self-protective national policies which have inevitably prolonged the recession. Because of the importance of buoyant external demand as a stimulus to national economic recovery, hope rests on the early resumption of economic growth in the major industrial countries (a 4 per cent. increase in 1976 is expected for OECD countries) and on access for the less developed countries to adequate finance to cover the payments deficits they must inevitably face for many years yet (see *International Developments, Autumn Bulletin, 1975*).

Recovery in export demand could pass Ireland by, unless our goods and services were competitive in price and quality and their sale yielded profits adequate to our future investment needs. It is regrettable that the oil crisis was

not recognised from the outset as an economic emergency requiring adjustment measures on the incomes and budgetary fronts. Failure to adopt cost restraints in time has aggravated the problem and made remedial action more difficult.

The Central Bank welcomes the Government's intention to implement a pay pause this year. If new wage and salary increases were to take place, the problem of Ireland's relatively high rate of increase in production costs would be aggravated. Costs so raised would not be reduced by any subsequent clawing back of wage and salary increases by higher taxation. The carry-over of increases from the 1975 National Pay Agreement will still raise the aggregate money income of non-agricultural employees by about 11 per cent. in 1976, roughly equivalent to the probable inflation rate for the year. With agricultural incomes likely to rise somewhat faster, and the savings ratio likely to decline to a more normal level, the upward trend in the volume of domestic demand should be sustained. In any case, further support for domestic activity must come from external sources, there being no room for additional expansionary moves through fiscal or monetary policy. One important advantage of a pay pause is that it would enable the economy to take full advantage of a rise in external demand as 1976 moves into 1977, by which time also the Exchequer should be reducing its borrowing in order to make way for increased private investment needs.

The budgetary indications for 1976 suggest a borrowing requirement greatly above even last year's abnormally high level. The Bank is particularly concerned at the precipitous plunge into current budget deficits since these were first deliberately and openly incurred a few years ago. A deficit on current account is not an exclusive or necessary and may not even be an appropriate way of expanding demand in a developing economy. As long ago as 1952 a note in the Book of Estimates for the Public Services pointed out that what is relevant to good management of the national economy is the total of public expenditure and how it is financed, and that it may not always be appropriate to meet even capital expenditure from borrowing. The Bank has repeatedly emphasised that expansion, when needed, in a developing economy can best be provided through increased capital outlay, public and private. The current budget deficit in 1972/73 was £5½ million; in 1973/74 £10 million; in 1974 (9 months) £92 million; and in 1975 £259 million. To arrest this ominous trend and restore some discretionary element to financial policy will require sustained action on several fronts - not only control of the huge pay component but also greater discrimination in the further improvement of social and other services and a strengthening of the tax base.

Amongst the consequences of recent trends in money incomes and public finance has been an excessive increase in the money supply. The budgetary deficits on current and capital account have led to the borrowing of very large amounts from the domestic banking system and from abroad. These borrowings contribute directly to the money supply and are of such proportions as to render monetary policy impotent.

In these circumstances the Bank cannot do other than continue to express its views on general economic policy and urge that priority be given to a progressive restoration of order in regard to money incomes and the public finances as a basis for resumed economic progress. It is appropriate that the Government should try in 1976 to finance a larger proportion of its borrowing requirements from non-bank domestic sources, building on its success in 1975 in this area. This would absorb some dormant savings and abate the alarming increase in payments in respect of external debt. It would be undesirable, in a possibly vain attempt to contain the large impending increase in the money supply, to restrict access by the private sector to bank credit for productive purposes. A realistic medium-term plan for the revival of the economy, on the basis of a reduced rate of inflation and competitive capacity, must also ensure that the private sector has the necessary resources, through retained profits and credit, to finance new investment.

Analysis and commentary should now give way to resolute and sustained action, guided by a medium-term plan, to remedy Ireland's economic and social problems. Without this, further emphasis on the gravity of the situation risks inhibiting the phased recovery, the confident resumption of investment and growth, on which policy and action should henceforth be focussed. The need for temporary restraints as a foundation for recovery and progress is widely recognised but, in the nature of things, it may be more reasonable to assume passive post-factum acquiescence rather than positive advance consensus."

The Minister, on 13 January, thanked me for my letter and said that I might be assured that the advice offered would be given serious consideration by the Government.

The budget, introduced on 28 January, 1976, envisaged, once again, a bigger increase in public expenditure than in national income, but was light on social welfare and heavy on tax increases.

There was a net increase of over £100 million in taxation, contributed largely by the "old reliables" (alcohol, tobacco and oils) and by increased rates of value-added tax and road tax.

On the day after the budget I made the following note, headed "Budget, January 28, 1976":

"For the record, I should set down that there was no consultation whatever between the Minister for Finance and myself about the terms of this Budget.

Mr. C. H. Murray had, of course, been in touch with us here in confidence about prospective Exchequer borrowing requirements and kept us up-to-date on the figures. He had also indicated that additional taxation of the order of £100 million was contemplated. It was not, however, until I heard the Minister in the Dail last evening that I knew whether it was direct or indirect taxation (or a combination) which was to be imposed, or what the particular items would be.

My main criticism, however, is that despite previous experience of letting budgets precede the regulation of incomes (especially last June) and the Minister's own repeated references yesterday to the essentiality of a pay pause, the mistake was again made of making budgetary dispositions before the course of money incomes was settled. If it was not possible to do this by advance agreement, it should have been done statutorily and the proposal to introduce legislation should have been announced in the budget as an accompaniment to the "non-pay" control legislation.

On the primacy of incomes control, see my letter of 5 December 1973 to Mr. C. H. Murray on treating the oil crisis as an economic emergency and "protecting ourselves against quite disproportionate inflation by statutory regulation of incomes of all kinds as well as prices". See also my m.s. note of 1 July 1975 on the June Budget, 1975 (copy attached)."

I was not alone in voicing such criticism. The leading article in the Irish Press on 29 January remarked:

"We are in for another cat and mouse game between the Government and the unions similar to that which was played in the early part of 1975. Last year, the unions pulled off the so-called national wage agreement which so embarrassed the financial provisions of the January, 1975 budget that we had a second budget six months later. A great part of public time, including that of the Oireachtas, was wasted on an issue which should have been decided before the year started."

My official contacts with the Minister and the Department were tapering off as the end of my term of office approached. The principal letter in February related to the question of Central Bank finance for the Government and has already been quoted (Chapter VII). There was never, however, any rupture of our good personal relations. The Minister, in a radio interview after my proposed retirement was announced in October, 1975, had been most generous in his reference to my public service. We said good-bye amicably when I paid my farewell visit to him on Friday, 27 February, 1976. My manuscript note is as follows:

With Minister from 3 p.m. to 3.25 p.m. He appeared to be anxious to keep talking - about the EEC loan, the pressure of Dail business etc. In the latter context, he spoke of doubt whether the Industry and Commerce Bill to protect depositors with Provident Societies would become law in the lifetime of the present Government. I stressed the urgency of closing this gap and gave an outline of our work in trying to straighten out the position of the smaller banks through restructuring, mergers and so on. In the end he asked how I saw the future. I replied that, given the discipline of a pay pause and a medium-term widely-agreed recovery programme, we still had a chance of being competitive when the rise in world demand began to be effective. We parted with mutual good wishes".

I went on to say goodbye to the Taoiseach. My note continues :

" The Taoiseach received me at 3.30 p.m. and I was with him for about a quarter of an hour. The conversation was very much to the point. I congratulated him on his law and order stance and suggested that similar firmness was needed on the economic side. It would have been better to ensure that the desired pay pause was firmly in place before the budget was introduced - in that event the tax changes could have been less severe. It was not reasonable to expect the advance agreement of the trade unions; surveys had confirmed before the budget that most workers would acquiesce in a pay pause and this should have been acted upon. In the Dail on Budget Day I said I had the impression that, second by second, Deputies were waiting for the Minister to announce the immediate introduction of a Pay (as well as a Non-Pay) Control Bill. I mentioned the futility, as far as restraining costs was concerned, of letting pay rise and then trying to claw it back by extra taxation. I voiced concern at the recent reversion to protectionist attitudes as evidenced by the reaction to the Irish Life contract for imported furniture. Free trade was the country's chosen policy - confirmed by the EEC referendum - and it was time the Government did something to restore a balanced viewpoint. The "flak" directed against the Irish Life Board could be seriously damaging - the Government would find it hard to get worthwhile independent persons to serve on State Boards if they had to endure such unfair criticism. Reference was made also to the controversy over the Bord na Mona Pembroke Street offices. Here the law was on the side of Bord na Mona, I said, and should be upheld against all other interests. My own experience was that the Dublin Civic Group and other preservationist lobbies did not hesitate to resort to unscrupulous smears and implications. The Taoiseach conceded that the Arts Council had not made their protest in time and were, strictly, "out of court". He thanked me for my public service contribution and asked me about future plans. I mentioned my reluctant acceptance of the Bord na Gaeilge chairmanship a year ago, my hope to have more time for this difficult task in the future, and my intention to take up not more than two directorships (which I named in confidence). The conversation was most cordial."

XI Management of External Reserves

The devaluation of sterling in November, 1967, rang the death-knell of sterling as an international currency. The sterling area, which had benefitted from the pooling of scarce dollars and other 'hard' currencies during the war and immediate post-war period, had become increasingly vulnerable to lapses of loyalty and trust as sterling staggered from crisis to crisis in the 'fifties and 'sixties. The co-operation in dollar economies and payments restraints which was mustered amongst a dwindling number of members in what proved to be a vain attempt to avert devaluation gave way in the immediate aftermath to a 'sauve qui peut' mentality. If sterling was never again to be dependable either in value or convertibility, there was no point in holding such large quantities of it in official reserves.

In our own case, apart from a small gold holding (£8 million) and some £16 million of U.S. Government securities, all our £300 million of external reserves in December, 1967, were in sterling, £147 million of that sterling being in the hands of the Central Bank. This predominance of sterling holdings could be justified if sterling were a stable and effective international currency but the unreliability and decadence indicated by resort to devaluation and other omens engendered a strong sense of anxiety. Ireland's pattern of international receipts and payments made it essential to hold a secure and readily available reserve asset: the Republic earned a net surplus in its transactions with the United Kingdom and other sterling area countries, it also usually earned a surplus with the dollar area, but it consistently incurred large deficits in its transactions with Continental Europe. It did not need sterling to pay its way currently with the sterling area: it needed to earn, and *a fortiori*, to hold in reserve, currencies or reserve assets which would secure its solvency in its economic relations with Europe. As uncertainty, at that time, still hung over even the deutschemark, the solution seemed to be a movement out of sterling into gold or dollars.

Towards the end of 1967 agreement was reached between the Department (where I was Secretary) and the Central Bank (Dr. Moynihan being Governor) on a policy of diversifying the external reserves. I explained our position to the U.K. Treasury: they did not welcome our intentions but could not resist the logic of our argument. It was agreed that, to avoid any undue repercussions on sterling, we would proceed quietly and by stages from March, 1968, onwards towards our objective which, as then defined with deliberate modesty, was to change about half the Bank's own sterling into other reserve assets.

While this diversification was proceeding in our case (mostly into gold as a first resort), similar and, in some cases, more drastic moves were being set in motion by other sterling area countries. The Treasury became alarmed. An arrangement was made under the auspices of the Bank for International Settlements in Basle whereby the Treasury obtained a line of credit from a number of lending countries which could be used to support the convertibility of sterling into various currencies in case of need. Armed with this 'last resort' facility, emissaries from Whitehall sped to the far corners of the world in the early summer of 1968 in an effort to induce major holders of sterling not to diversify further into dollars or other reserve assets. The bargain offered was that, in return for committing themselves to hold a minimum proportion of sterling in their reserves, varying from holder to holder but intended to stabilise the June 1968 level of sterling holdings, holders would receive both a guarantee of the minimum dollar value (\$2.40 = £1) of their holdings and an assurance that, if they needed to draw down their reserves for balance of payments reasons, the proportionate sterling element in the draw-down would be convertible into 'hard' currencies out of the international stand-by credit which Britain had arranged.

In common with most other sterling area countries we decided, though with considerable reluctance, to agree to this bargain but not before we had arranged that £40 million of sterling would be transferred from the Associated Banks to the Central Bank and would be covered by the dollar-value guarantee. By the agreement, the sterling assets

in excess of 10% of our total official reserves were guaranteed against devaluation in terms of the U.S. dollar. The minimum sterling proportion we originally agreed to maintain was 65% but this was adjusted later, particularly to take account of the centralisation of the net sterling assets of the banking system in the Central Bank which was completed in the course of 1970.

Before the Basle arrangements became effective, we had gone some distance in diversifying our reserves. Between March, 1968, when the process began and the close down that Autumn, the Central Bank reduced its sterling holdings by £33 million (25%) and correspondingly increased its holdings of gold and U.S. dollars and its creditor position in the International Monetary Fund. This creditor position (of £11.6 million) had a gold value guarantee, was repayable on request and yielded a return of 1½%. It was as an interim arrangement that the greater part of the diversification was into gold, held to our account in the U.S.; it was intended to move into more remunerative and mobile reserve assets when a better view could be taken of how the international monetary system might settle down. The "gold window" through which this gold was bought was closed by the United States in August, 1971, and central banks had already (since March, 1968) bound themselves not to sell gold in the market but only to transfer it between themselves at the official price (then \$35 an ounce). The Central Bank's gold holdings, recorded at £31million in December, 1968, had been halved by December, 1969 and reduced to their pre-diversification level by December, 1970. I remember we calculated at the time that the realisable price of gold would have to be doubled at least every five years to compensate for the loss of interest on dollar securities. This seemed improbable so long as Central Banks bound themselves to an official price and foreswore free market sales.

In May, 1969, the Bretton Woods Agreements (Amendment) Bill, providing for Ireland's acceptance of and participation in the Special Drawing Rights Scheme, became law. The legislation provided also for the transfer to the Central Bank of the functions previously performed by the Minister for Finance in relation to payments to and receipts from the International Monetary Fund. The assets represented by the gold tranche and by the creditor position were also to be vested in the Bank. All this was

in conformity with the principle that the ownership and management of the external reserves should be in the hands of the Central Bank. The Minister had reminded the Dail in reply to a Parliamentary Question on 10 December, 1968 that "in accordance with the provisions of the Currency and Central Bank Acts, the employment of the funds in the custody of the Central Bank is a matter for the Bank".

The position was made more explicit in a letter which I sent to our representative on the IMF Board as Alternate Executive Director (Mr. Maurice Horgan) on 18 September 1969. The relevant extracts are :

"As an appropriate division of labour - particularly in view of the changes made by the Bretton Woods Agreements (Amendment) Act, 1969 - it has been agreed with Finance that the Central Bank should henceforth be the Irish authority to be primarily consulted by the Fund on all matters relating to the size, composition and use of Ireland's external reserves (e.g. quotas, participation in drawings by other countries from the Fund, SDRs) and on technical problems relevant to the Fund's work (e.g. greater flexibility in exchange rates). The Central Bank will consult the Department so far as any question of policy or principle may be involved and, indeed, for its view on other matters, too. Perhaps you could so arrange. The presence of Charlie * and myself in Washington will provide an opportunity of clearing up any point you may wish to raise. Of course, matters (e.g. voting) requiring the Minister's attention as Governor for Ireland should go direct to him.

The other side of this division of labour is that all matters relating to the World Bank and its affiliates are primarily for the Department of Finance."

The reduction in the Central Bank's gold holdings during 1970 was amongst the factors which prompted a series of Parliamentary Questions on the Bank's autonomy in this and other areas. I have already referred (Chapter 111) to our objection to the inclusion in the Minister's reply to a Question on 16 June, 1970, of the Bank's reserves and investments as matters frequently the subject of consultation with the Minister and to our assertion of these as being "within the authority of the Board".

There were some members of the Dail for whom gold continued to hold its time-old fascination, Dr. John O'Donovan in particular. He asked several questions about the sale of gold by the Bank in the course of 1970, including a query as to whether the Minister for Finance had been consulted. The Minister said "I was not consulted. The management of official monetary reserves is a

* Mr. C. H. Murray, then Secretary of the Department of Finance

matter for the Central Bank, acting within its statutory powers" (Dail Debates, 10 November, 1970). Dr. O'Donovan pressed the Minister : did the Minister agree with the decision of the Central Bank to "get rid of our limited amount of gold". The Minister's reply repeats the Bank's description of its policy (Annual Report, 1970, pp 52/53), while re-asserting the Bank's independence :

Mr. Colley : It is not my function to agree or disagree. The Central Bank is by statute charged with the duty of deciding whether or not our reserves in the form of gold or otherwise should be disposed of. The bank has set out its general policy in this regard. I might, however, set it out briefly. The policy is that in the management of external reserves their objective is to obtain as large a return as possible on the reserves consistent with, firstly, Ireland's commitments as a member of the IMF and as a participant in the Basle Agreement to safeguard the stability of the international monetary system, secondly, the necessity of keeping a sufficient amount of reserves in liquid form and, thirdly, the maintenance of their international value.

Dr. O'Connell : What is the reason on this occasion, or did they tell the Minister ?

Mr. Colley : The reason is obvious : you do not get interest on gold.

This was not the last we were to hear of gold. The baleful yellow metal continued to excite covetous instincts. Dr. John O'Connell T.D. inquired in July, 1973, as to the total value of the country's gold reserves. Deputy Oliver J. Flanagan, asked on 20 June, 1974, why the Minister for Finance favoured a reduction in the role of gold in the international monetary system and why the proportion of gold in Irish official reserves had declined at a time when the free market price of gold was rising. The questions and the reply are worth reproducing :

Mr. O. J. Flanagan asked the Minister for Finance whether, in view of the growing international monetary and financial crisis arising from the deficit with the oil producing countries and of the flood of depreciating paper currency in the world, he will state why he considers that the role of gold in the monetary system should be reduced.

Mr. R. Ryan: As I informed the Deputy in the course of my reply on 28th May last to a previous question, there is general agreement in the international community that the role of gold in the international monetary system should be reduced. That is the conclusion of the Committee of 20 on International Monetary Reform, which has just concluded an intensive study of monetary problems, including the gold problem. That committee has had available to it the services of experts from the International Monetary Fund and from all the member countries of the fund.

The supply of gold available for monetary use is variable and uncertain, depending on the level of world production and the demand for gold for industrial, commercial, hoarding and other purposes. It is now accepted that this does not provide a firm basis for the creation or management of international liquidity in modern economies. Instead, the committee of 20, with whose report I fully agree in this respect, has opted for the adoption of the special drawing right - popularly known as the SDR - as the primary international reserve asset. In this way the volume of liquidity can be brought under the control of the International Monetary Fund and can be regulated by that body in relation to international need and in the interest of the world community.

What I have said relates to the long-term position of gold. It does not mean that the substantial existing stocks of monetary gold cannot be drawn on to meet deficits resulting from the higher oil prices or other reasons. This, however, is a complex question which is still under consideration.

Mr. O. J. Flanagan asked the Minister for Finance why the proportion of Irish official reserves held in gold declined from 5.6 per cent. to 1.7 per cent. between 1969 and 1973, at

a time when the free market price of gold was continually rising; the manner in which the gold reserves were disposed of; and, if they were transferred or sold to other countries or interests, if he will give details including the selling price.

Mr. R. Ryan : The proportion of the official external reserves held in gold declined between 1969 and 1973 because of gold sales valued at £5.1 million in 1970 to the United States Treasury at the then official price of U.S. \$35 an ounce, an increase in the Irish subscription to the International Monetary Fund of £4.3 million paid in gold in the same year and because total reserves increased subsequently while the volume of gold holdings remained constant. I may add that :

- (i) the free market price of gold did not begin to rise significantly until the second quarter of 1972;
- (ii) in official external reserves gold is valued at the official price, currently \$42.22 per ounce. The Central Bank's transactions in gold in 1970 were carried out in accordance with an agreement of March, 1968, between central banks to conduct gold transactions only among themselves at the official price:
- (iii) the Central Bank has received substantial interest payments on official reserves held in U.S. dollars and other foreign currencies.

Mr. Colley : Is it true that one of the reasons for the position as outlined in the question and in the Minister's reply is that gold, when held at fixed official price, does not, of course yield interest as do other forms of reserves, as pointed out by the Minister ? Would the Minister further agree that it would be in the interests of this country to establish an international monetary system based not on superstition but on a rational system such as SDRs ?

Mr. R. Ryan : The Deputy is entirely right.

When the Basle agreements were renewed for two years in September 1971, the Minimum Sterling Proportion was reduced by 10 per cent in each case. Ours, which had earlier gone from 65% to 68%, was thus reduced to 61 per cent. Advantage was taken of this to diversify further.

The incredible revaluation of sterling vis-a-vis the U.S dollar in the Smithsonian arrangements at end-1971 was predictably short-lived. The floating of sterling in June, 1972, further reduced its significance as an international currency. Its dollar value quickly fell from the post-Smithsonian \$2.6057 to about \$2.35 in the final quarter of 1972. Indeed, one of the matters which came under consideration in early discussions on reform of the international monetary system was the possibility of consolidating reserve currency holdings of Central Banks into "modified" Special Drawing Rights in the IMF. This proposal never became operative but we did point out the need for an adequate rate of interest on any SDRs which would replace our sterling and dollar holdings. The floating of sterling also caused the U.K. authorities to suggest modification of the guarantee provisions of the Basle arrangements. The Central Bank was not in favour of a renegotiation, on the view that Ireland should be released from the Basle restrictions as the only sterling area country, apart from Britain, which was acceding to the EEC. If this argument proved untenable, we should press hard for a much lower Minimum Sterling Proportion in order to have greater freedom to diversify. In the end, while the British never formally conceded our argument that additions to our reserves resulting from foreign borrowing should be excluded in computing the MSP, they did admit that they would no longer insist on applying the MSP to a rise in reserves but would be content to agree on an absolute limit more or less equivalent to the then level. On this basis, a prolongation of the guarantee and MSP arrangements was again agreed.

To complete the story of the Basle arrangements, this prolongation carried us up to September, 1973, and we faithfully maintained the Minimum Sterling Proportion at around 60%. A unilateral proposal was then made by the British authorities to renew the Agreement for six months even though their stand-by credits were being allowed to run out. I expressed the following views to Mr. C. H. Murray on 13 September, 1973 :

"What should our attitude be? I have a strong preference in principle for freedom to manage our reserves and hold as much, or as little, sterling as we ourselves think fit. My first approach, therefore, is to compare what we would be likely to be able to do over the next six months to protect the value of our reserves, if we had freedom to move out of sterling, with the position we would be in if we accepted the new offer. Taking a reasonable view, I have to assume that, without attracting adverse notice or even forcing down the sterling exchange rate, we would scarcely be able to move more than, say, £50 million of our sterling into dollars or European currencies in so short a period. While this part of our sterling holdings would thus be safeguarded (at some loss in the interest yield), the bulk would still be at risk and would be unprotected by any British guarantee. It is also reasonable to assume that the U.S. dollar will continue to strengthen against sterling.

I prefer, therefore, to turn to the possibility of arranging that acceptance of the offer in our case would be in such terms that we would have much the same practical scope (i.e. of the order of £50 million) for reducing our present high level of sterling reserves, while retaining for the time being the British guarantee in respect of the remainder.

What I have in mind is that, relying on the (British) idea of a "limited MSP", we would get agreement in our case to an absolute limit of, say, £190 million or £200 million for our sterling holdings (now at £239 million), the new MSP being of the order of 50 per cent. and not applying at all to any increase in reserves. The guarantee should cover all the sterling in our reserves. I need not at this point develop the arguments we could advance but they include the following: (a) our unduly high initial holdings of sterling (b) the increase in these and the extent to which this reflects external borrowing and (c) the new relationships and obligations arising out of our joint EEC membership.

From informal conversations over the past week-end in Basle with the Governor of the Bank of England and Executive Director Kit McMahon, I believe that qualified acceptance (or even rejection) of the British offer would not be interpreted, at least by the Bank of England, as a hostile act. They showed appreciation of our problems. We also have the advantage that, in so far as major sterling holders like Hong Kong have had to be placated with the \$2.4213 guarantee, and the British must now try to defend that rate, there is more scope for bargaining manoeuvre on details for individual smaller holders like ourselves. I would be happy to try to bring the Bank of England along (so that they would say the right things to the Treasury), if the suggestion I have made above commends itself to the Department.

Finally, I think this recent experience suggests that we and other sterling holders can justifiably claim the right to much earlier consultation before the six months run out.

We accepted the offer of prolongation of the guarantee to end-March, 1974. Before the end of 1973 we were being consulted as to our view on the post-March 1974 situation, the Chancellor of the Exchequer having invited the opinion of the Minister for Finance on the action he should take "to provide stability for holders of sterling pending the devising of a long-term solution to the sterling problem in the context of international monetary reform". The Bank still felt (my letter of 29 November, 1973) that it would be better to seek separate treatment from other sterling holders by virtue of our common EEC membership with Britain. The Bank considered that countries not participating in the "snake" arrangements would be subject to no formal limitations on their holdings of EEC partner currencies. If there were a further extension of the September 1973 declaration - and this would be preferable to a formal bilateral agreement - the Bank would envisage a reduction of £100 million to £150 million over the following three years in its sterling holdings but doubted whether the United Kingdom could concede a general reduction of this order to sterling area countries. Finally, the Bank emphasised that an improvement in the quality of the guarantee (it was to be related to the effective exchange rate of sterling, not just to its rate with the US dollar) should not be regarded as an acceptable alternative to diversification of reserves. Guarantees were temporary and, under the new regime, at the volition of the guarantor. "At their expiration one risks being left holding reserves denominated in a currency which is still liable to depreciation".

A unilateral extension was made by the U.K. authorities guaranteeing a reduced Minimum Sterling Proportion of about 54 per cent of total reserves for the period ending 31 December, 1974. This freed 6% of our sterling for immediate conversion into other reserve assets. The so-called Basle arrangements finally lapsed on 31 December, 1974.

Ireland received a payment of £3.8 million under the Basle guarantee when, in the winter of 1972, the floating pound fell for thirty consecutive days below \$2.40 by more than one per cent. One of the aims of the U.K. Treasury in suggesting a modification of the arrangements in September 1973 was to be empowered to claw back any such payments if and when sterling recovered again for the requisite period.

In fact, the floating pound had strengthened from about \$2.48 at end-March, 1973, to \$2.58 at end-June. It then weakened steadily to \$2.16 in mid-January 1974 but recovered at end-May, 1974 to almost \$2.40. The upshot of all this was that not only did we collect a second guarantee payment, making the total £11.1 million, but, in anticipation of the ending of the Basle arrangements in December, 1974 we were able to arrange substantial switches into U.S. dollars at rates close to \$2.40.

It was also possible to switch into deutschemarks and other "snake" currencies, which were appreciating in relation to the U.S. dollar, at a time when sterling was showing some temporary strength, as it did in the Spring of 1975.

Basle, which had been the scene of the support arrangements for sterling, was also the place where I informed the Governor of the Bank of England in late 1974 of our intention to convert from sterling into other reserve assets and where I arranged with the President and Vice-President of the Bundesbank that, within liberal limits, they would countenance our use of the deutschemark as one of our reserve assets, even though they were opposed to the development of reserve status for the DM. I also arranged that the Central Bank could hold balances, on a smaller scale, in Dutch guilder, French and Belgian francs, Canadian dollars, Japanese Yen and other currencies. I may say that the reaction of the Governor of the Bank of England, Mr. Gordon Richardson, was stoical, as had been that of the Secretary of the Treasury (Sir William Armstrong) in 1968. The understanding of our attitude by the principals did not extend all the way down the line and murmurs were heard of the dependence of access to the London capital market and other benefits on continued membership of the sterling area.

The upshot of the process of diversification of our external reserves, begun in 1968, in large part but not wholly arrested during the régime of the Basle agreements, and resumed at the end of 1974, is to be seen in the following table :

Official External Reserves (£ million)

<u>31 Dec.</u>	<u>Gold</u>	<u>SDRs</u>	<u>Reserve Position in IMF</u>	<u>Sterling</u>	<u>Other Foreign Exchange</u>	<u>Total</u>
1967	8.0	-	-3.7	265.8	16.3	299.4
1968	31.0	-	11.6	218.3	30.6	291.5
1969	16.1	-	24.2	183.0	64.6	287.9
1970	6.7	5.6	12.6	191.3	74.1	290.3
1971	6.5	11.0	14.7	217.3	131.6	381.1
1972	6.9	16.4	16.9	264.1	127.9	432.2
1973	7.6	16.4	16.9	259.9	134.5	435.3
1974	7.6	17.0	17.7	208.6	244.5	495.4
1975	7.6	17.2	16.0	128.7	506.5	676.0

The diversification of reserves was initiated by public servants and carried through by them with unremitting zeal and determination and without the intervention of Ministers except as protocol required. It is one of the most satisfying achievements of my period as Governor of the Central Bank, ranking only after the strengthening and widening of the administrative and technical competence of the Bank and the maintenance of an excellent esprit de corps.

XII. REFLECTIONS

Looking back over the period I have been reviewing - from early 1969 to early 1976 - I would like first to take stock of the broad changes in the economic, financial and social scene, as distinct from the shorter-term vicissitudes with which, as the earlier chapters show, policy-makers were mainly concerned in this troubled septennium.

The net increase in GNP was about 25 per cent in real terms, the nominal rise being from about £1,300 million to nearly £3,700 million. Consumer prices doubled; the mid-February index for 1976 being 236 as against 103 for 1969. Agricultural incomes increased by 175 per cent, non-agricultural by just over 200 per cent. The cumulative balance of payments deficit on current account was over £600 million. Government expenditure, current and capital combined, rose as a percentage of GNP from 38 per cent to 49 per cent. The gross capital liabilities of the State trebled from £914 million to £2,660 million; outstanding foreign debt accounted for a mere £55 million in March 1969 but for £523 million in March 1976, and had topped £1,000 million by the end of 1976!

A major critical concern of the Central Bank was the rise in unit wage costs here relative to Britain and other competitor countries. Taking 1970=100, unit wage costs in Ireland had risen to 134 by 1973, as against 121 for Britain but by 1975 they had come virtually level (198 versus 196) and for 1976 the comparative indices were 213 and 221. In contrast, the 1976 index for Germany was 135 and for the United States 142, figures which vividly illustrate how essential for competitiveness was the sharp decline in the exchange rate of the pound in relation to the deutschemark and the dollar.

During the period the population was increasing at the rate of 1% per annum but employment was not expanding fast enough to absorb both the new additions to the labour force and those still leaving agriculture. The "flight from the land" exceeded the number of new jobs in industry and services; unemployment increased from 60,000 to 90,000 and emigration continued, though on a moderate scale. In the first Report (1968/69) of my term of office the three principal domestic threats to the integrity of the currency, even in the limited sense of parity with sterling, were picked out for comment - excessive public expenditure and borrowing, excessive credit creation, excessive income increases. Up to and including the final comment for which I was responsible - that of the Winter Bulletin of 1975 already quoted (Chapter X) - the Bank's criticism focussed on the errors or deficiencies of fiscal, monetary and incomes policies.

The Bank never held the view, apparently favoured by some economists, that the parity link with sterling provided an automatic and painless mechanism of adjustment, obviating the need for concern about relative deviations in incomes, prices and costs, and, therefore, for domestic initiatives to correct them. The Bank acknowledged the long-term influence of the parity link in bringing about a convergence of prices - though this could be disturbed by different policies in the two countries regarding indirect taxes and subsidies - but it never saw the adjustment process as a painless one. If prices tended higher here and, in particular, if production costs were being raised faster here by immoderate pay increases, the "adjustment" took the unpleasant form of diminished competitiveness, loss of jobs in affected industries, stimulation of imports and widening of the external payments deficit. Restrictive fiscal and monetary measures were called for to protect national solvency. The form of inflation produced by excessive public and private expenditure, supported by borrowing from the banks and abroad, was, in the Bank's view, no less dangerous than that which revealed itself directly in price and cost increases; both had adverse effects on the external balance and correcting the imbalance necessarily jeopardised employment. The path of virtue was to keep the Irish trend in prices and costs slightly below the British so as to give a competitive edge to a widening range of goods and services and thus assist the expansion of exports and jobs.

The Bank's views on fiscal policy have been clearly indicated in the various chapters of this Memoir. If a summary is to be given, I doubt if I could do better than quote from the Bank's 1975 Report:

"The course of public expenditure, taxation and borrowing in recent years was the subject of a special article in the 1972/73 Report. The rate of increase in public expenditure has swept ahead even of gross domestic expenditure in money terms. Public finance is absorbing a rising proportion of total national output: total public expenditure, current and capital, which represented 30 per cent. of GNP in 1961/62, now represents at least 42 per cent. of GNP. This drive to obtain extra resources for public purposes conflicts with private spending aspirations and sets up inflationary tensions. Prices and costs are raised by the need to increase indirect taxes and by the general effect on wage and salary demands of what people consider to be excessive Government "take". In effect, no attention is paid to the argument that price increases due to taxes imposed to redistribute income should not reckon as a basis for further income increases. The private sector in general has shown itself unwilling to yield up the

purchasing power which the Government seeks to obtain for public purposes through taxation and borrowing.

The rapid increase in current budget deficits is occasioned primarily by rising pay, social welfare and debt service provisions, not matched by equivalent taxation. The Bank does not accept that current deficits on this scale are justifiable as a means of expanding demand; this need, when it arises, could more appropriately be met by increased capital expenditure. The external indebtedness of the Government and State bodies already exceeds the total of Ireland's external reserves and is mounting fast. There is special cause for anxiety when increased current expenditure, which makes no contribution to relieving the real burden of the debt redemption process, is one of the main objects of such borrowing."

The Bank never entertained extravagant notions about the scope or efficacy of monetary policy in the context of a virtual monetary union with Britain. Again, let me quote a typical comment (from the 1975 Report):

"The Central Bank has only a limited capacity to safeguard the integrity of the currency in the sense of maintaining its domestic purchasing power as distinct from its exchange value in relation to sterling. The reasons were fully stated by the Bank in its 1968/69 Report. It is appropriate that credit policy, being part of general economic policy, should be aligned with the basic economic objectives of the Government. These objectives are, however, not always mutually compatible and the policies actually pursued do not always result in their being fully realised. The Central Bank has not failed to draw attention to the principal forces which tend to frustrate achievement of the desired aims and, instead, to promote excessive inflation. These forces have been so strong in recent years that an attempt by the Central Bank to suppress excessive inflation by severely restricting the money supply would produce an unacceptable degree of economic and social distress. In such circumstances, the Bank's purpose, having given the best advice it can on policies and objectives, is to try not to aggravate inflation by allowing a larger increase in the money supply than will permit the attainment of the major economic objectives of the Government."

The whole subject was reviewed at greater length in a talk I gave to the Commerce and Economic Society of U.C.D. on 5 November, 1975, reproduced as Appendix 2. This will serve as a record of the role the Bank saw itself qualified to fulfil in relation to monetary policy.

The Bank showed that it was prepared to use its limited, but by no means negligible, powers in the qualitative as well as the quantitative sense both to support expansionary policies with which it agreed and in other circumstances to exercise a restraining influence on both the import and the domestic creation of money. The major weakness was not any lack of loyal conformity on the part of the commercial banking system but the possibility of such restrictions being overcome by the Government's financial needs and its discretion to borrow abroad.

In the last resort, of course, and particularly if the Bank were to attempt, even with full Government backing, an unacceptably severe restriction on private sector access to credit, a large part of the money needed by Irish trade and industry could have been supplied by British financial sources: only the small concerns and the less well-off individuals would be left out in the cold. The full operation of monetary policy would require strict exchange controls and an exchange rate system similar to the European Monetary System which we are now (January 1979) committed to enter. It remains to be seen how far what is technically possible will be politically feasible.

Monetarist doctrine has impressive theoretical coherence but I remain sceptical of attempts to substitute an automatic regulator for management by society of its own affairs, however imperfect at times such management may be. I cannot see how a democratic community could reasonably be expected to accept being placed in a monetary strait-jacket by its own Government unless it were persuaded of the equity and desirability of such a discipline. It is unthinkable that any Government could use monetary policy, even if it were so minded, to grind trade unions or other important interest groups into submission. I continue to believe that democracy can be made to work, not through reliance on automatic regulation or enforced discipline, but through informed discussion of options and objectives, leading to a wide measure of acquiescence and co-operation. Statutory regulation has its proper place in "traffic-sign" situations, where, in its absence, chaos would rule and where its presence serves to protect an orderly majority against disruptive and selfish actions by a small minority. The Central Bank has, for example, always expressed its support in principle for the underpinning by law of agreements on pay reached by representative bodies with at least some regard for the national interest.

Guided by this socio-political philosophy, no less than by recognition of the limited scope in an open economy for Keynesian ideas of demand expansion, the Central Bank has devoted a great deal of its attention and advice to the importance of general acquiescence in a moderate rate of growth of money incomes. No effort has been spared to explain

the harm that can be done by disproportionate income increases in raising production costs, destroying competitiveness, enlarging balance of payments deficits and in all these ways putting jobs at risk. Much of the correspondence quoted in this Memoir relates to incomes policy and Appendix 3 contains a selection of significant extracts from Bank publications on the same topic.

One must conclude that, however important its licensing and regulatory functions vis-à-vis the commercial banks and its power to create and issue money, the Central Bank's main function as a public authority cannot be other than that of trying to influence Government policy in favour of protecting, to the utmost, the value of the monetary unit. The advisory role of the Bank is supremely important. How it was performed in the 1969-1976 period is outlined in this Memoir, which documents the views and advice of the Bank, supplementing in various ways the already-published material. What degree of success was achieved - indeed, whether the advice ought to have been better observed, or more largely ignored - is, no doubt, best left to historians to judge. Nevertheless, some impressions of one close to the events may not be out of place.

As to how far advice was listened to, one might, on the surface, take a pessimistic view. There was hardly ever more than a polite acknowledgment of the Bank's written submissions, and views expressed orally were usually heard in silence, though in a receptive rather than a hostile atmosphere. One may, however, suppose that warnings of dangerous trends and reminders of what was right did not fall entirely on deaf ears but had at least some corrective or restraining effect. I need not underline that this is a more qualified statement than Dr. Moynihan's conclusion:

"However sceptical it might sometimes be regarding the wisdom of Government economic policies, it had no reason to fear any calamitous departure from the paths of financial orthodoxy, and it was supported by the knowledge that its advice had been received with, at least, understanding and sympathy by successive Ministers for Finance".*

In our period of review, the temptations to stray from financial orthodoxy were stronger and not always resisted. The Central Bank's advice, expressed both in private and in public, rarely produced converts in Government circles, though it may have heightened a consciousness of guilt and been a safeguard against worse excesses! One salutary factor was the continued growth of the Central Bank's public reputation for independence, efficiency, honesty and technical competence: this made its public pronouncements harder to ignore.

* Currency and Central Banking in Ireland, 1922-60, page 475.

We do know, from memoranda submitted to the Government, that the Minister for Finance often shared the same concerns as the Bank. He was not always successful, however, in winning over his colleagues and a not surprising inconsistency can be detected at times between the economic analysis and remedial prescriptions in the opening part of budget speeches and the fiscal decisions announced later. The fact is that neither shortage of money - foreign borrowing on the whole was too readily available - nor any effective external discipline (arising out of EEC commitments to co-ordination of economic policies) was really of any great effect in limiting the freedom of Government action in the period surveyed.

Dr. C.H. Murray and I appear very often in this Memoir in attitudes of confrontation and it is time I corrected any false impression this may convey. Each of us was carrying out his particular function, within the context of his own loyalties and convictions, just as I had done in relation to Dr. Moynihan when he was Governor and as, no doubt, Dr. Murray himself is doing today in relation to his successor in the Department. I am gratified that our verbal arguments never spoiled our good personal relations. There was much in common in our upbringing, training and development; indeed, we entered the Civil Service on the same day and in the same office and both of us acquired London University degrees by private study. We had collaborated to good effect in the preparation of "Economic Development" (1958) and we became close colleagues when Dr. Murray, at my prompting, joined the Department of Finance to head the new Economic Development Branch, later the Development Division. As I found from experience, there are seeds of difficulty in the relationship between a Secretary of the Department of Finance and the Central Bank Board, of which he is also a member, and particularly between him and the Governor as full-time Chairman of that Board. But, with understanding, these difficulties can be minimised, the more so when the parties recognise that they have more in common than divides them and, in particular, that fundamentally they share the same anxieties and objectives.

I was extremely fortunate in my No. 2 at the Bank, Bernard Breen. He was general manager in the full sense of the word. He ranks in the highest category of administrators with whom I have closely collaborated. Utterly reliable and competent, he is endowed not only with outstanding common sense but also with courtesy and kindness. One of my last acts was to remind the Minister for Finance of Bernard's qualities and of the submission I had made that he be considered for appointment to the Board as Deputy Governor or, at least, as an executive director. The record of my farewell talk with the Minister contains the following passage:

"I also recalled that when speaking to the Minister on 2 April, 1975, I had urged the desirability of providing some full-time support for the Governor, either by legislating for the appointment of a permanent Deputy Governor or by using the existing statutory provisions under which a member of the Board can be given additional executive functions. I emphasised the desirability of matching the normal organisation of Central Banks elsewhere; it was desirable that those who attended meetings of Deputy Governors in the EEC should at least have the status of Board members like their other colleagues. An appointment of this kind would also provide a top prestige post for staff, with the possibility of a suitable staff member eventually becoming Governor - though there should, on the other hand, be no closed shop situation as far as Deputy Governor or Governor are concerned. I mentioned Mr. Breen as an obvious appointee to the kind of position I had in mind. The existing powers could be used with the Minister's co-operation either when a vacancy occurred in the Board or if the number of possible members of the Board were increased by fresh legislation."

Regrettably, this, my last piece of advice, like so much that went before, was to go unheeded!

My term as Governor of the Central Bank which, as noted in Chapter 1, began under seemingly good auspices ended on a note of disappointment. I have no sense either of surprise or grievance over this: I take it to be a not infrequent experience of Governors of Central Banks. I am glad that I was able to maintain good terms personally with those whose policies I criticised. There is a great measure of satisfaction in having had a part in bringing the extended functions of the Central Bank into play, in seeing its efficiency increased and its status raised. It is served by an extremely competent and co-operative staff. When all positions were opened up to women, equal pay was arranged from the start before custom or legislation so ordained. We may now, at any time, have a General Manageress or a Governess, unless we have the good sense to accept the concept of neuter gender for the designations of our highest posts! Finally, I think it can be claimed that a nationally useful relationship with the Government was maintained with a high measure of independence, but with due observance of the basic principles of democracy; in other words, the Bank respected the Government's final authority but faithfully discharged its critical and advisory functions and was, in no sense "the Government's creature".

APPENDIX 1STAGES IN THE EVOLUTION OF CENTRAL
BANKING IN IRELAND, 1942-1968

Between 1942, when the Central Bank was established, and 1954 none of the central banking functions conferred on the Bank by Section 7 of the 1942 Act was exercised. It was not until after Dr. McElligott became Governor (on 1 April, 1953) that these functions began to be activated. The process continued during Dr. Moynihan's Governorship (1960-1969). Following are some of the more important stages:

6 January 1954: Purchase of Dollars for General Fund.

Having secured Treasury acquiescence, I suggested to the Governor of the Central Bank by letter of 12 November 1953 that the Bank should acquire dollars equivalent to the annual erosion (about \$1 million) of Irish dollar assets through sales in London and the dollar area. The Governor notified me on 6 January, 1954, that the board of the Bank had agreed to purchase for the General Fund up to \$1 million per annum.

Jan.-Feb. 1955: Modification of parallelism between British and Irish interest rates.

At the instance of the Department of Finance, with the concurrence of the Central Bank, the commercial banks agreed not to raise their lending rates when Bank of England rate was raised in January and again in February 1955. This was the beginning of the policy of differentiation described in Dr. Moynihan's book "Currency and Central Banking in Ireland" (pp 420-422 and p.426) and further discussed in Chapter VI of this Memoir. It was always recognised that scope for manoeuvre in the matter of interest rates is limited to a mere curbing of a trend, a temporary easement or deferment of its impact. This was explained in the Budget statement of 1955 and at greater length in a speech made by the then Minister for Finance at the annual dinner of the Dublin Stock Exchange on 20 December, 1955.

13 April, 1955: First rediscount operation.

The first credit-creating transaction of the Central Bank was the rediscounting of tea bills for Tea Importers Ltd., and it originated in a suggestion by the Department of Finance to the Governor of the Central Bank on 5 April, 1955.

20 December, 1955: Rediscounting of Exchequer Bills for commercial banks.

Agreement by the Central Bank to rediscount Exchequer Bills for the commercial banks arose out of pressure by the Department of Finance on the commercial banks for temporary finance at a time of depleted bank reserves.

22 August, 1956: Admission of US dollar securities as assets of Legal Tender Note Fund.

This was a logical extension of the arrangement made in January, 1954, for the purchase of dollars for the General Fund. I had discussed it with the Governor of the Central Bank as a means of freeing the resources of the General Fund for rediscounting of Exchequer Bills while continuing to add dollars to the national exchange reserve as a re-insurance against weakness of sterling. The unanimous request of the Board of the Central Bank was transmitted to the Minister for Finance on 10 August, 1956.

6 November, 1956: Purchase of "capital" dollars even at a premium.

When "capital" dollars became available for purchase by Irish citizens (i.e. dollar proceeds of sales of assets, legacies, emigrants' remittances, etc.) I obtained the agreement of the Governor of the Central Bank that all available capital dollars would be purchased by the Central Bank, even at a premium, in preference to allowing them go to London.

November, 1958: Settlement of internal clearances of commercial banks.

This had been under consideration by the Board of the Central Bank for some time and had been foreshadowed by the Minister for Finance in a speech on 5 February, 1957.

March, 1959:

Admission of Irish Government security as asset of Legal Tender Note Fund.

In response to the request of the Department of Finance (14 January, 1959), the Central Bank agreed to make an advance to the Minister for Finance under Section 3 (7) of the Bretton Woods Agreements Act, 1957, to finance an increased subscription in gold to the International Monetary Fund. A unanimous request from the Board to the Minister to make an Order adding "Irish Government security for advances under Section 3 (7) of the Bretton Woods Agreements Act 1957" to the list of assets in which the Legal Tender Note Fund may be held was conveyed to the Minister in March, 1959. It was further agreed by the Central Bank in June 1960 to advance an additional £3 million approximately to the Minister for Finance under the same Section.

November, 1961:

Transfer of part of Legal Tender Note Fund to General Fund.

An Order was made on 29 August, 1961, at the request of the Central Bank adding the item "Balance in General Fund" to the list of assets in which the Legal Tender Note Fund may be held. In November, 1961, in order to increase the resources of the General Fund and give it wider scope for its rediscounting and lending operations, UK government securities and cash amounting to £20 million were transferred from the Legal Tender Note Fund to the General Fund and replaced by a corresponding "Balance in General Fund". This internal rearrangement meant that the resources of the General Fund, which amounted to about £20 million before the transfer, were doubled.

13 May, 1965:

Letter of Advice on Credit Policy.

On 13 May, 1965, the Governor of the Central Bank sent the initial letter of advice on credit policy to the Associated Banks. This followed a proposal by the Irish Banks' Standing Committee that a statement of the Central Bank's views on domestic credit and on Government financing by the banks should be conveyed to them. The May letter was the first of a series of communications from the Central Bank which sought to achieve an appropriate relationship between the credit policy of the banks, the growth in their resources and the requirements of the domestic economy.

30 September, 1965: Six per cent Funding Loan.

At the beginning of September 1965 the Minister for Finance sought an additional £18m. from the banks. To meet this requirement in full, while complying with the Central Bank's advice (May 1965) on credit policy, would have involved severe curtailment of credit to the private sector. An arrangement was made under which the Central Bank purchased on 30 September from the Associated Banks £20.5 (nominal), 6% Funding Loan, 1969, which had been specially issued to the banks by the Minister for Finance. The Minister then paid off £20m. of Exchequer Bills which matured on 30 September (£13.7m. of which were held by the Central Bank and £6.3m. held by the Associated Banks). On the same date the Associated Banks took up £18m. of fresh Exchequer Bills. As a result of these transactions there was an increase of £11.7m. in the Associated Banks' holding of Exchequer Bills and this had been made possible by the Central Bank acting as lender of last resort.

See also Chapter VII of this Memoir.

19 April, 1967: Money Market.

The Board of the Central Bank agreed on 19 April, 1967, that the Governor should set up a committee to examine and report on the functions that might be performed by an active money market in Ireland, the methods of operation of such a market and the practical steps that might be taken to facilitate its development. The committee reported in October 1968 and its report was published on 2 May, 1969.

November 1967: Diversification of Reserves.

This matter is dealt with in Chapter XI of this Memoir.

T. K. W.

APPENDIX 2.

APPENDIX 3INCOMES POLICY

Significant extracts from Central Bank publications.

From Quarterly Bulletin, Spring 1974 (article on "Inflation and Money Incomes") :

The essential elements in the Central Bank's view in relation to incomes, as expressed over the last five years, are as follows:

- (1) The Bank has supported both the analysis and the broad recommendations of the Report on Incomes and Prices Policy issued by the National Industrial Economic Council in February 1970. These included a proposal for a body to review pay relativities.
- (2) The Bank sees national policy as being concerned with raising both real incomes and the number of acceptable jobs. The Bank has explained how these aims can be thwarted by the pursuit of unduly high rates of increase in money incomes. When money incomes increase much faster than productivity, costs and prices are inevitably raised. If this happens faster in Ireland than elsewhere, the market prospects for Irish products are curtailed and, since exports are the key to expansion, economic and social progress is retarded. A more moderate and orderly evolution of money incomes is seen by the Bank as a necessary element of any general policy directed towards achieving full employment. The Bank is convinced that economic expansion and community welfare will be better assured by acceptance of the attainable real improvements in income by way of more moderate money increases coupled with a slower rise in prices.

- (3) Increased productivity, as indicated by the expected national growth rate, is now a normal element in pay increases. Any further recognition of productivity for pay purposes must tend to raise costs and prices. If a high inflation rate is to be avoided, it is only in genuine cases of exceptional improvements in productivity and even then only in moderation that increases in pay over and above the agreed "national" norms can safely be allowed.
- (4) Where agreement on wage and salary increases for a period ahead is reached at national level, and is consistent with the basic interests of the community, the Central Bank has indicated that it would favour the giving of statutory force to such an agreement, as is done in most Continental EEC countries.
- (5) A wider economic and social setting for bargaining on pay increases appears to the Bank to be desirable. This point is developed further below.

While progress has been made on the institutional plane in recent years, with the negotiation of National Pay Agreements under the auspices of the Employer / Labour Conference, the establishment of the National Prices Commission, and the formation of the National Economic and Social Council, it is not yet sufficient and has not so far curbed inflation.

A number of economists whose normal preference would be for free operation of market forces have expressly recognised the need for some form of control of the rate of increase in money incomes if inflation is not to keep on accelerating. The transition from recognising this principle to applying controls in practice has not, however, been easy to effect, or maintain for long, in most democratic countries. It is all the more desirable that sustained efforts be made to achieve the required moderation through education and persuasion and on the basis of as wide agreement as possible.

While the merits of National Agreements have been widely noted (the advantages of the most recent one were indicated in the recent Budget speech), one cannot overlook their defect of appearing to deprive individual unions of an adequate field of action and, on the economic plane, the fact that their effect has been to aggravate rather than reduce inflation. The inconsistency between the large money awards agreed by the two parties to National Agreements and the rather small productivity gains achievable annually at national level may be partly a function of the restricted horizon of the parties to a traditional collective bargaining system. Neither trade unions nor employers' organisations are yet fully conscious of the urgent need to reduce inflation. The unions still have a greater immediate interest in pushing wages ahead of prices, while employers hope that it will continue to be possible to pass on higher costs not only in the home market but also in external markets themselves sustained by inflation. There is no provision for ensuring that collective bargaining is informed or guided by a realistic assessment of the outlook at home or abroad or of the longer-term national interest. Adherence to the prospects ahead, and particularly to the conditions on which maximum progress depends, and a broad consensus as to the social and economic development principles to which Government policies will conform, appear to be essential elements in a process which so largely determines the

competitive position of Irish goods and services and, indirectly, the rate of national progress.

This extension of the horizon of the negotiators of pay increases could, perhaps, result from continuous studies within the framework of the National Economic and Social Council. The Council might try to assess the longer-term resource and growth prospects, the conditions of maximum economic and social progress and the policy choices open in relation to taxation, social welfare and the trend of prices, real incomes, productivity and employment. These assessments, and the principles of policy agreed by the Government in the light of them, would then be available to the Employer/Labour Conference and other negotiating bodies. The National Economic and Social Council has the advantage, for this wider task, of a membership representative of interests other than simply employers and trade unions, in particular Government departments, the Central Bank and independent persons, and its own expert secretariat. Even those who react against the Government, as such, rather than merely as employer, having a seat at the bargaining table, might well consider it unreasonable to object to having the bargaining related more closely to the wider interests of the economy and the issues appraised as competently and objectively as possible. Until this is somehow arranged, there is every risk that national wage and salary settlements will increasingly undermine the value of money and operate against the longer-term social and economic interests of the community. Such an arrangement, on the other hand, might help not only to prevent relatively high inflation in Ireland but to bring about a lowering of the absolute annual rate of price increase.

The foregoing outline of the "social contract" idea differs from others to which public expression has recently been given. It is not, for instance, considered appropriate, as has been suggested by the Federated Union of Employers, that the bargaining about any particular round of pay increases should include specific commitments by the Government regarding taxes or social welfare benefits. An immediate and direct linkage of this kind would deprive the Government of the freedom of action it needs in order to manage the economy in the best interest of the community as a whole. It does, however, seem appropriate that bargaining on pay issues should be more clearly informed than hitherto by a recognition of all its economic and social implications and that the parties to the negotiations should have, as a frame of reference, the best assessment possible of the principles and policies to be observed over three or four years ahead in order to ensure the steady growth of the economy and acceptable progress in the direction of full employment and a fairer social order.

From Quarterly Bulletin, Winter 1974:

The Bank's view is that the safeguarding of employment and living standards must be the predominant aim of policy but that this could be made an impossible task if money incomes were to keep on increasing at the rates now current. Neither the industrial, nor the agricultural, nor the service sector could afford to pay such increases to all who now hold jobs: markets and profits lack the necessary buoyancy. Indeed, there is so little scope for expansion of domestic activity, with the external deficit and foreign borrowing already so high, that a combination of high money income increases and reflationary action could only lead before long to greater unemployment and redundancies. High money income increases for all simply could not be financed and any significant increase in domestic activity is out of the question unless there is moderation of income increases.

From Annual Report, Spring 1975 :

Despite the critical importance of pay increases for the economy as a whole, the Government is not represented as such in national pay negotiations between representatives of unions and employers The rising scale of money incomes poses the greatest threat to new and even existing jobs. Expansionary fiscal policies can offer no release : with incomes escalating, such policies are nullified in their employment effects and quickly run into balance of payments constraints. The price of job preservation is income restraint.

From Quarterly Bulletin, Summer 1975 :

It is becoming more widely understood that the present rate of increase in money incomes of those at work not only closes off new jobs but causes additional unemployment and makes it extremely dangerous to attempt remedial action by way of further expansion of Government expenditure, requiring more massive foreign borrowing. Granted a lower level of income increases for those still at work, there need be no fear of any fall in total demand; on the contrary, as the Bank has repeatedly pointed out, public and private productive spending could then be expanded in the interests of employment both with greater effect and with less risk.

From Quarterly Bulletin, Autumn 1975 :

The need to contain the growth of current Government expenditure and to cut down current budget deficits particularly by restraining the rise in money incomes is basic in the fight against inflation and unemployment. It is most regrettable that this was not seen as an emergency requirement as soon as the price of oil was quadrupled at the end of 1973. The degree to which it is recognised, even at present, is inadequate.

From Quarterly Bulletin, Winter 1975 :

Real incomes can over time rise only in line with real growth; attempts to secure more than this by way of inordinate increases in money incomes merely add to production costs, damage competitiveness and cause unemployment. To give policy-making perspective and consistency a flexible form of medium-term planning, with full involvement of the major economic interests, is desirable. The course of public expenditure as well as of personal incomes needs to be well ordered in the interests of national progress.

