Patrick Honohan: T K Whitaker Lecture “Design flaws of the euro”

Introductory remarks by Mr Patrick Honohan, Governor of the Central Bank of Ireland, for the T K Whitaker Lecture “Design flaws of the euro” by Mr Harold James, Princeton University, Dublin, 1 February 2013.

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Exactly 70 years ago today, the Central Bank of Ireland opened its doors, with the “general function and duty of taking… 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.” Objectives these that resonate with the Central Bank’s current mission statement: *Safeguarding Stability; Protecting Consumers*.

The new Bank assumed and expanded the role its precursor, the Currency Commission, had performed for 15 years before that. Creation of the Central Bank partly followed a global fashion. As Minister for Finance Seán T. Ó Ceallaigh remarked in the second stage speech on the legislation creating the Bank, 23 countries had created central banks in the period 1921–36. We know that underlying this wave of creation had been the desire by long-term Bank of England Governor Montagu Norman to create an international network with which he could deal on financial issues without having to work through Governments. The central forum of this network was the Bank for International Settlements, whose Economic Advisor, Per Jacobsson, was an influential member of the Irish Banking Commission 1934–38. This Commission has been set up by the Fianna Fail government to see what needed shaking-up in Irish banking and it did, albeit without evident enthusiasm, duly recommend that Ireland should follow the new fashion. It seems that both the Bank of England (with whom Jacobsson stayed in touch during the Banking Commission’s deliberations) and the Irish banks, especially the Bank of Ireland, had misgivings about extending the wider powers of central banking to the Irish case, given the close ties to London.

“Measaimíd,” arsa Seán T., “gur ciallmhar an mhaise dhúinn ár gcóras airgeadais féin do chur in oiriúint do réim an lae inniu.” But more likely it was the uncertainty about being able to rely in wartime on the traditional smooth access to liquidity in London, as evidenced by the rebuff given to the Bank of Ireland there when it made exploratory inquiries in September 1939, that was the proximate trigger for the Government (supported by many opposition deputies) to take the plunge. And so was created an entity which, unlike its predecessor, would have the power and resources to increase “the cash reserve of …banks [which] will thereby be in a position to lend more freely and so set the wheels of trade and industry in motion again.”

This exciting prospect did not, however, enthuse William Norton, leader of the Labour Party, who opposed the Central Bank Bill saying that it “in fact, is really eye-wash” and, as *The Economist* had already written, “likely to be little more than the existing Currency Commission under a new name.”

As it turned out, most of the new powers acquired by the Bank, such as lending to and taking deposits from banks and Government, did indeed remain largely unused for a couple of decades. And the one-for-one sterling exchange rate link remained firmly in primary legislation until 1971. It was not until the early 1970s – the Whitaker years – that it could be said without fear of contradiction that the Central Bank was no longer operating as a mere Currency Board.

Even in the 1970s, public communication was simpler than it is today. For example, the Governor was able to muse publicly on exchange rate policy without fear of the message reaching the London money markets by the simple expedient of speaking in Irish: (see T.K.

Whitaker’s 1976 talk, printed in the Bank’s 1976 Annual Report: “An Ceangal le Sterling: An Cheart é a Bhriseadh?”)

Thereafter change came relatively rapidly as the Central Bank had to respond to a changing external environment. Creation of the European Monetary System did bring the foreshadowed end to the sterling link in 1979, but the new and brittle exchange rate regime was associated with acute monetary management challenges at a time of acute domestic fiscal pressure. The EMS crisis of 1992–93, which saw banks having to borrow from the Central Bank at 100 per cent interest rate, culminated for the Central Bank in a weekend – exactly twenty years ago – that saw both a celebratory concert to commemorate the Bank’s golden anniversary, and the final EMS devaluation of the Irish pound.

The emergence of the IFSC in subsequent years was the catalyst for a great expansion in financial regulation: this still places the heaviest demands on the Central Bank in terms of staff resources assigned to authorising, regulating and supervising the very large number of firms and funds involved in the business of exporting financial services.

Adaptation of the national system to comply with the requirements of the euro absorbed much of the Bank’s work in the 1990s and into the new millennium, while a new emphasis on consumer protection responded to acknowledged weaknesses in that area. Our currency centre rose to the challenge of printing a share of the new euro notes, with ever improving security features.

But the design of the euro, topic of tonight’s T.K. Whitaker lecture to be given by Professor Harold James of Princeton University, did not, as many had assumed, protect members from macro-financial distress.

The past few years have been probably the busiest ever for the Bank as it has raced to stem or meet outflows and repair the damage to the banking system that has so undermined national prosperity. With industry promotion no longer part of the Bank’s statutory mandate, the regulatory agenda has shifted into an unapologetically intrusive mode. Regulations are being enforced with sizable penalties imposed for violations. A graduated but intensive and unremitting programme of specific required deliverables is being imposed on the banks to try to ensure that they will deal effectively with the admittedly challenging task of getting ahead of the still-growing mortgage arrears problem, both by getting those who can back on schedule, and modifying loans in the case of those who cannot do so. The Bank is currently also playing its part in engaging with external partners in seeking to limit and smooth the impact on Irish balance sheets of the indebtedness accumulated as a result of the overly expansive decision to socialise banking losses, to help accelerate recovery of employment on a sustainable basis.