Mr. O’Connell reports on the Irish economy and different aspects of the Central Bank of Ireland’s activities Statement by the Governor of the Central Bank of Ireland, Mr. Maurice O’Connell, to the Joint Committee of the Oireachtas (Parliament) on Finance and the Public Service in Dublin on 18/2/97.

I thank you for your invitation and I welcome the opportunity to appear before this Committee.

Internationally, the economic outlook remains generally good. While the crisis in Asia has reduced forecasts, there is still optimism that reasonable growth with low inflation will continue. Worldwide, there is a strong consensus on the merits of price stability and reduced budget deficits as the best platform for growth and employment.

In Europe, the picture is mixed. In general, there has been some improvement in the past half year and a growth rate not far off 3 per cent on average is predicted for 1998. The prospects for substantial reductions in unemployment in the short term remain disappointing. Unemployment in Europe is seen largely as a structural problem that can only be resolved over an extended period. On the positive side inflation has been subdued and interest rates are relatively low. As we move towards the deadline for decision on membership of EMU, there is a great awareness everywhere, in shaping policy, of the requirements to satisfy the entry conditions.

The Irish economy

Ireland’s position is unique at the moment by European standards. Economic growth has continued to exceed expectations. The Central Bank expects that growth this year will be of the order of 7 to 8 per cent. Others might put the figure higher. While growth will probably slow down in the years ahead, it should remain well above the European average. The Central Bank estimates that a long-term growth pattern of the order of 4-5 per cent is within our capability, if the international environment remains benign. This will depend on a number of factors, not least continuing low inflation. The current national wage arrangements provide a solid basis for cost competitiveness and it is most important that these terms are not diluted. Unemployment is below the European average. The progress on job creation in recent years is impressive and the outlook is good.

In its quarterly report published in December the Central Bank forecasted an average inflation rate for this year of 2½ per cent, which is relatively low in absolute terms and is within the threshold for qualification for EMU. The subsequent decline in the Irish pound has increased the prospect of a somewhat higher figure. There are other factors such as asset price increases and tightening conditions in the labour market, which also carry the potential for overheating of the economy and higher inflation. These are a source of concern because they could ultimately damage the economy.

One feature of the strong performance of the economy is the growth in private sector credit. The cumulative growth in the past three years was over 50 per cent and it is now increasing at an annual rate above 20 per cent. As we started from a level of indebtedness relatively low by international standards, growth on this scale may not be a cause of immediate alarm. On all previous experience, however, it would be unsustainable in the longer term without inflationary consequences. The ready availability of credit at relatively low interest rate levels has been a contributory factor to the excessive rises last year in house prices which are now at historically high levels in real terms and by reference to average earnings. House prices have risen by 40-50 per cent since 1994. There are predictions that a further substantial rise in prices this year is likely. We may not be far from a situation where home ownership will be beyond the reach of persons on average incomes.

There seems to be a perception that the Central Bank can exercise some legal authority in restricting credit. It has no such authority. Any restriction would be inconsistent with European Union practice. Besides, it would be unworkable as demand would probably be met by overseas lenders. The introduction of the single currency will facilitate access by overseas lenders. The Bank continues to monitor the conditions applied by the credit institutions in lending for house purchase. It has warned these institutions repeatedly of the dangers inherent in high rates of credit growth and any relaxation of lending standards. Insofar as the Bank can establish, 100 per cent mortgages have been issued only in exceptional cases where properties were being purchased for investment. The Bank would not encourage this practice and the credit institutions have been so advised.

Economic and monetary union

Preparation for EMU is a dominant feature of the work of the Central Bank at the moment. Our duty is to ensure, as best we can, that Ireland continues to fulfil the entry requirements, in particular the requirement on inflation, and that the banking and financial system in general is well prepared for the single currency.

It now seems virtually assured that EMU will start on schedule on 1st January 1999 and that a substantial majority of European Union countries will participate from the outset. Control of monetary policy will pass immediately to the Governing Council of the European Central Bank and decisions will be made on the basis of European requirements. We will no longer be able to adjust the exchange rate or interest rates to correct domestic problems. The priority of the European Central Bank will be price stability. Besides, the conditions of the Stability and Growth Pact effectively require that member countries run a balanced budget over a complete economic cycle.

The preparations for monetary union at operational level are well advanced, under the aegis of the European Monetary Institute. Much of this work is of a detailed technical nature relating to business between the individual central banks. The EMI has recommended two possible monetary policy strategies for the European Central Bank - monetary targeting and direct inflation targeting. Among the other important strategic issues are the extent of decentralisation, management of reserves, pooling of reserves and monetary income and linking of payment systems. There are some awkward issues yet to be resolved. The definition of monetary income for instance is a problem.

In the single currency regime there will be a deliberate policy of decentralisation and the day-to-day activities of the Central Bank will be conducted within this framework. We will continue to manage reserves and to provide liquidity to the banks. We will, however, work to guidelines or benchmarks determined by the Governing Council of the European Central Bank. In certain areas of the Bank the working day will be extended. Our preliminary arrangements for production and stockpiling of euro banknotes and coin are well under way. While the deadline of 1st January 2002 may seem distant, we must begin production far in advance.

There have been reports to the effect that the Central Bank will have a large surplus of reserves when we join EMU. This is misleading. At the end of 1997 the Bank had total assets of £6½ billion. These assets were matched by corresponding liabilities of £5 billion, leaving net assets, or internal reserves, of nearly £1½ billion. The Bank will continue to need internal reserves. I would not speculate on an appropriate level. We may not need the present level of reserves in due course but it is too early to make a judgement on this until we have experience of the new system. All of the other national central banks participating in EMU will be in a similar position. Our internal reserves as a proportion of total assets are about average by European Union standards. I might add that any transfer of internal reserves would reduce future earnings and profit transfers to the Exchequer.

From 1st January next onwards, all Central Bank business will be conducted in the new currency, the euro. All accounts with the Bank, whether held by credit institutions, the Government or international institutions, will be in euro. Existing notes and coin will become constituent parts of the euro. The banks generally must be ready to make any banking service required in Ireland available in euro. From January next, they will process lodgements and payments in Irish pounds or euro, as required. It would be reasonable to anticipate that Irish business in general will move to the euro faster than the official timetable requires.

The National Changeover Plan, published some weeks ago, draws attention to arrangements for the period of transition pending the introduction of euro banknotes and coin. During this period banknotes of the member States participating in EMU must be exchanged at par value. From January the Central Bank will provide an inward exchange service free of charge.

Exchange rate/interest rate

I am under the usual constraints in regard to comment on current exchange rates and interest rates for the Irish pound. These issues are highly sensitive. Determination of exchange rate policy is the prerogative of the Minister for Finance. It has been decided that the method for arriving at the conversion rates for the different currencies, including the Irish pound, will be settled and announced at the time of decision on EMU membership. This decision, it now appears, will be taken on 3rd May. Nothing further has been decided at this stage in relation to fixing of exchange rates.

The intention to pre-announce bilateral rates in May is driven by the general concern throughout Europe to avoid market speculation as we move closer to the January 1999 deadline. While national authorities will continue to be responsible for the exchange rate of their respective currencies up to this deadline, the May agreement should have a decisive influence and should diminish the possibility of considerable fluctuations.

There has been substantial convergence of interest rates in Europe in recent months. Irish interest rates, at the short end of the scale, though low by historic standards, remain substantially above levels across much of Europe. There has been a good reason for this. It reflects domestic conditions here as the economy has continued to be exceptionally buoyant and the threat of overheating remains. If we were not on the doorstep of EMU, our interest rates would now be higher. Wholesale interest rates must converge, among the countries participating in EMU, by January 1999. This points to the expectation of reductions in Irish rates, even if European rates were to move upwards further in the meantime. I cannot quantify reductions precisely nor can I outline a timepath. It is evident, however, that some reductions of significance are likely. In the meantime, Irish interest rate policy will be influenced by the requirements of the domestic economy. The Central Bank will retain the discretion to adjust rates for as long as possible.

I might also draw the attention of members to the impact on savings. In a lower interest rate regime some deposit rates must inevitably come down. The returns on call deposits in particular are already at very low levels. It would be unwise to assume that interest rates will remain permanently low once the euro area is established. As with the US dollar, successful management of the euro will require periodic interest rate adjustments to secure the objective of price stability.

In the context of EMU, the relationship with sterling is of obvious concern to us. We now know that the UK will not join EMU for some time ahead. It would be better for us, if it joined at the outset. I cannot predict future movements of sterling relative to the euro. I would, however, point to the Treaty requirements that all member States should treat exchange rate policy as a matter of common interest. This applies as much to the UK as to anybody else. The Bank of England will participate in the General Council of the European System of Central Banks and will be subject to the obligations that this imposes. I would further suggest that the decision last year to give operational independence to the Bank of England is significant in this context. It is working to an inflation target and this arrangement should reduce the likelihood of large-scale fluctuations of sterling vis-à-vis the euro.

It is vitally important that the credibility of the euro is established immediately. To achieve this the new currency must be supported by a solid economic background and political consensus. There is considerable speculation about the merits of a hard or a soft currency. The critical factor is that the currency be stable in terms of European prices so that its international role will be secure and that, in time, it will challenge the dominance of the US dollar. The external value of the euro will be largely determined by the monetary policy implemented by the European Central Bank and by developments in the foreign exchange markets for the major industrial currencies.

Supervision

May I now turn to a different aspect of our activities.

The Central Bank's approach to supervision reflects European legal requirements and is in line with best international practice. The basic objectives of supervision of banks and building societies are to protect depositors and investors and to ensure as far as possible that risks to the financial system as a whole are minimised. Insofar as the Bank examines individual customer accounts, its focus is always on the solvency of the institution. Our main attention is focused on the quality of loans and other assets and good management. We frequently come across breaches of the rules. Many of these would be of a minor nature. Most are dealt with by administrative action. We discourage applications for banking licences unless we are fully satisfied as to the status of the applicant.

No system of supervision, however comprehensive, can give a one hundred per cent guarantee against abuse. Effective supervision requires the co-operation of the entity that is being supervised. Despite the improvements in controls, and international co-operation, bank failures continue. The ultimate objective worldwide is to avoid systemic problems.

Arising from the Tribunals of Inquiry and other recent developments, there has been some confusion about the confidentiality exercised by the Central Bank in relation to its functions. May I say at the outset that we are co-operating to the fullest extent possible with Tribunal investigations.

Members are aware that the Central Bank is conducting an investigation following recent allegations against National Irish Bank. I am precluded from discussing individual cases.

The Bank is bound under law, to observe strict rules of confidentiality. It may not disclose information about individual entities or persons to any third parties, other than in exceptional circumstances. These include criminal proceedings in court, providing information to the Gardai on money laundering and other criminal activity, including tax evasion, and transfer of information to other regulatory authorities. The Bank is prohibited from communicating information to the Revenue Commissioners. We are not tax investigators. It is the duty of individual financial institutions to report to the Gardai suspicions of criminal activity (including tax evasion) by their customers. I understand that such reports to the Gardai are not infrequent. If we become aware of tax abuse, by an institution that we supervise, it is our duty to notify the Gardai.

These requirements derive from and are consistent with European Union laws. Other banking supervisors in the European Union are subject to similar confidentiality requirements. Our situation is in no sense unique. If the Irish authorities attempted to abandon these requirements, not only would we be in breach of EU law but we would forfeit the co-operation of other supervisors in exchanging information. This exchange of information is vital. Without it, we simply could not operate as a competent supervisory authority and operations by Irish banks abroad would be called into question.

The supervisory duties of the Central Bank have been extended considerably in recent years. The International Financial Services Centre continues to expand. Last year responsibility for all investment intermediaries was assigned to the Bank. In response, we have contacted more than one thousand intermediaries in order to compile a register and to develop a code of conduct. The supervision of small retail operations is a new departure for the Bank and it may take some time yet to settle on a definite pattern of operation. A further complication is that a majority of intermediaries are also engaged in insurance and other activities which are not the responsibility of the Central Bank. It makes little sense to examine investment operations without taking some overview of the total business of an intermediary.

Exchange controls have also been in the news. In operating these controls up to their abolition in 1992, the Central Bank acted as agent for the Minister for Finance. The Bank may give information on these matters to the Minister only.

Irish financial institutions

Irish banks and financial institutions generally have been returning consistently strong profits. This is unsurprising in view of the favourable conditions for lending and minimising bad debts. At the same time, operating margins have been reducing significantly in the face of sharper competition. All indications suggest that competition will intensify further in the years ahead. There will be expensive technological developments and competition from outside will be facilitated by the single currency in EMU. It would be reasonable to predict that there may be significant rationalisation within our financial system in the period ahead. It would be disappointing if this resulted in a situation where the great proportion of Irish banking was controlled from outside. I should also mention the impressive overseas expansion by a number of Irish financial institutions in recent years.

We live in a world of large-scale movement of funds across borders and Ireland is no exception. Given the open nature of the Irish economy, it is no surprise that cross-border holdings of funds in our case are relatively high.

The total volume of deposits, excluding interbank deposits, with banks and building societies in Ireland is estimated to be in the region of £60 billion. Roughly one third of these deposits are held by non-resident companies and individuals. This proportion is quite high by international standards. On the other hand deposits held abroad by Irish residents - again excluding interbank figures - are in the region of £11 billion. This figure is high by international comparison. The figure has quadrupled in the past ten years, reflecting the growth in Irish trade, the removal of exchange controls in the context of the single European market and the development of the International Financial Services Centre.

This covers only the deposit side of the picture. Borrowing by Irish residents from overseas banks has also grown rapidly in the past decade. It is now estimated to be of a similar order of magnitude to overseas deposits. Access to credit abroad at competitive interest rates, growth in the multinational sector and the IFSC have contributed to this development.

This is by no means a comprehensive picture. It does not incorporate cross-border flows in securities and other investments such as equities, for which we do not have specific information. The Central Bank is aware throughout every day of the broad quantities of funds moving in and out of Irish pounds across the foreign exchange market. It does not have knowledge of the movement of funds on behalf of individual bank customers.

Conclusions

Before I conclude, may I refer again briefly to monetary policy. In the implementation of monetary policy the first objective of the Central Bank at all times is price stability. This will also be the first objective of the European Central Bank and this is made abundantly clear in the Maastricht Treaty. Price stability is the best foundation for a growing economy and for continuing improvements in employment. This has been demonstrated consistently, not just in the Irish situation but worldwide.