Maurice O'Connell: The euro, the Irish economy and banking supervision

Written submission by Mr Maurice O'Connell, Governor of the Central Bank of Ireland, to the Irish Parliamentary Joint Committee on European Affairs on 19 July 2000.

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The outlook for the world economy remains generally good. Europe has settled into a steady growth pattern and real GDP growth of more than 3% is expected this year. Unemployment is falling steadily. The US economy has continued to surpass expectations and there are now tentative signs of orderly slowdown. Japan and the Far East generally appear to have shaken off the threat of financial collapse, though recovery in Japan is still tentative. A policy of zero interest rates and high public expenditure has not been enough to stimulate growth. The remarkable performance of the US economy has generated euphoria about a so-called new economy that offers the prospect of a permanent reduction in the natural rate of unemployment, substantial gains in productivity growth and lessens the risks of inflation. Whether or not we are in a new economy, or a new information revolution, it would be unwise to conclude that traditional laws of economics no longer apply. There are new factors, but, whether these are a temporary phenomenon or a profound change, only time will tell.

The world economy may appear fit and well but there is an imbalance that will require correction at some point. I refer to the record deficit in the current account of the US balance of payments, which is being financed by capital inflows from Europe and Japan. This may not continue indefinitely. Capital will flow to wherever the strongest future return is perceived to be. The possibility of a sharp stock market correction also deserves attention. Between end-1996 and end-1999 the Dow Jones index rose by 78%, while the Nasdaq index, which accounts for about one third of total stock market capitalisation in the United States recorded an increase of more than 200%. In Europe, structural weaknesses have continued to be a dead hand on the economy and reform is by its nature slow. In this context, the current taxation proposals in Germany may prove to be a very significant development. Very recently the OECD has issued warnings on the dangers of inflation both in the United States and in Europe.

When I came before this Committee in February, I mentioned that the succession of economic crises in recent years had prompted the authorities to review comprehensively the whole international financial architecture. This review is ongoing and the Financial Stability Forum (a body set up by the G7 to promote international financial stability) issued a report on offshore centres recently, as part of its mandate. Earlier this year, reflecting the new emphasis on financial stability, the International Monetary Fund sent a team of experts to Ireland to investigate our arrangements for supervision of the financial sector.

The euro

The euro has been continually in the limelight, largely because of the downward trend against the US dollar and other currencies. Since its introduction on 1 January 1999, the euro has depreciated by almost 20% against the dollar. There has been a welcome improvement in recent months, reflecting the improvement in the underlying economy. It has been a source of concern that, as a new currency without an extended track record, the credibility of the euro might be damaged by undue weakness. The reasons for the relatively weak euro have been analysed repeatedly. Essentially, it reflects the robust performance of the US economy. The euro is undervalued; it should recover substantially as the European economy improves and as familiarity with the currency increases. The current level of long-term bond yields confirms market expectations of continuing price stability in the euro area. Large swings in currency external values are by no means a new phenomenon in the world order. In the mid-1980s the Deutsche mark was considerably weaker against the dollar than the euro is today. Within two years, this position was reversed.

There has been some criticism from time to time of the management of the euro at international level. This criticism has pointed, in particular, towards the multiplicity of spokespersons on behalf of the currency. Yes - there were too many opinions in the early days but this is now behind us. It has been an extremely complex operation to bring 11 countries together into one monetary policy area. It is a tribute to the professionalism of many that the transition has been achieved in such a straightforward manner. While attention may have focused largely on the external value of the euro, the primary objective of monetary policy is price stability within the euro area which is seen as essential for economic success, social justice and balance in society.

Although the euro has been weaker than expected since its launch, the prospects for the currency have been improving steadily. Where, last year, the weakness against the US dollar largely reflected an unexpected divergence in economic growth between the two areas, this differential has now narrowed and is expected to continue to do so over the course of this year and next. On a broader scale, the euro is the second largest currency in the international financial system and the euro area represents an internal market of almost 300 million people. With exports from the area accounting for almost 20% of world exports and integration of financial markets progressing further, the currency has considerable potential to appreciate.

The European Central Bank is now fully operational. At the political level, the euro 11 (soon to become the euro 12) has gradually defined its role as a forum for economic policy coordination among participating Member States. This includes a continuing dialogue with the Bank to ensure consistency of policy. It is probably fair to say that the euro cannot be fully fledged and expect total acceptance until banknotes and coin become available. Production is well under way to meet the target date of 1 January 2002 (known as E-day). People will then relate immediately to the euro as their currency. There is great confidence that this will have a big influence in cementing the euro zone further.

The European Central Bank does not target an exchange rate for the euro. Large economic zones do not target an external anchor. This does not imply that the Bank is indifferent to the level of the currency. On the contrary, if at any stage the level of the euro were a threat to price stability, the Bank would obviously respond. The Bank adopts a twin-pillar strategy in the conduct of its monetary policy. These pillars are growth in money supply and inflation.

The Annual Report of the Central Bank of Ireland for 1999 reflects the extent to which EMU and the euro impact on the functions of the Bank. There have been changes of radical dimensions. The Bank is part of the Eurosystem and it no longer operates an independent Irish monetary policy. It does of course contribute to monetary policy for the euro area. The Irish pound is no longer traded on the foreign exchange market. The Eurosystem is decentralised so that operational activities are carried out by the individual national central banks. In short, our day-to-day activities are more complex than before. The Bank continues to manage reserves, to engage in open market operations, provide standing facilities and to operate payments systems. It is constantly liaising with the European Central Bank in Frankfurt on all aspects of our activities that relate to monetary policy.

Right now, Ireland’s situation within the euro area is unique because of our exceptionally buoyant economic conditions. It follows that the monetary policy of the European Central Bank is not best suited to current Irish circumstances. The European Central Bank cannot address our situation in isolation. The Irish economy comprises just 1% of the euro area GDP and it would be entirely implausible to expect that the strategy for the whole euro area might be coloured by conditions that are peculiar to us. In any event all members of the Governing Council of the European Central Bank are obliged by law to adopt a euro area-wide perspective, rather than represent a region or a constituency. This is the main reason why the European Central Bank does not publish minutes of meetings, in order to avoid any semblance of national pressures.

The European Central Bank does not focus on individual countries. It does not differentiate between big and small. It does not draw distinctions between so-called core and peripheral countries. This language is not used. Monetary policy is set for the whole euro area as one unit. At the moment, however, economic conditions in Ireland differ substantially from conditions elsewhere. We have joined EMU, however, for the long haul - for the benefits of relatively low inflation, low interest rates and the general security that membership of a large currency area provides.

Interest rate movements are obviously an important factor in determining the future course of the Irish economy. Internationally, the bias in interest rates is upwards as the world economy maintains a positive momentum. Nobody would rule out at this time the possibility of higher rates; for us, rates are now determined by the policy of the European Central Bank by reference to economic conditions in the euro area as a whole. The adoption of the euro involved a large and arbitrary reduction in Irish interest rates in 1998. This has to some extent been reversed and since November 1999, there has been a cumulative increase of 1.75%. Higher rates would better suit Irish conditions as interest rates here are still negative in real terms at the prevailing rate of inflation. This invites overinvestment. As mentioned already, policy must be determined however by reference to the euro area as a whole. Membership of the euro area will continue to require disciplines and benchmarks and provide stability from which we should benefit substantially in the long run. This is one good reason for optimism about the future of the Irish economy.

The Irish economy

The Irish economy continues to exceed best expectations. Before addressing difficulties and potential problems, may I acknowledge achievements. We are in an economic position that most would envy and successive administrations deserve credit for this. The problems that we address today are problems of success.

The Central Bank estimates growth this year will be 8½%. There is little evidence of a slowdown. This level of growth cannot be sustained. The signs of overheating of the economy are already evident. Labour shortages, congestion and accelerating house prices are testament to this. There is a dilemma. On the one hand, there is a large budget surplus and an obvious need for high investment in areas such as infrastructure. On the other hand, an expansionary approach to the budget tends to generate overheating, to increase the threat of inflation and ultimately undermine the competitiveness that has got us where we are today. There is no simple nor definite answer. There is no alternative, however, to restraint. This restraint must extend to incomes and to current expenditure generally. The pay terms and tax reductions contained in the Programme for Prosperity and Fairness (PPF) should deliver real income increases over the period of the agreement. It is important that the economy is not undermined by wage drift.

The dilemma that I have outlined is not simply a matter of economics. It also involves political and social choices, which are outside the remit of the Central Bank.

The Central Bank estimate of average inflation for this year on a CPI basis is 4¾%. Last year the average was 1.6%. Put in context, this means that Irish inflation will be substantially beyond the average for the euro area this year. Nobody claims that inflation here must be at the same level as in the euro area in general. It is reasonable to expect that inflation would be somewhat higher than the average, because of our economic growth and higher productivity growth. The gap, however, has become too wide. Inflation is expected to go higher in the months ahead before it goes lower again. On favourable assumptions, especially in relation to energy prices, the Central Bank forecasts an average inflation rate of 3¾% in 2001. High and sustained services inflation could push this higher.

Perhaps the greatest threat at the moment is a wage-price spiral that could get out of hand. The danger is that expectations might become detached from reality at a time when the economy’s scope for increased output is diminishing because of supply constraints.

It has been suggested that higher inflation may be a suitable route to a soft landing and that there may be no need to worry about inflation. This proposition, which undoubtedly has superficial appeal, overlooks the dynamics of the inflationary spiral that could lead to a very sharp deterioration. It also overlooks the difficulty of regaining competitiveness once it has been lost. It is not so long ago since the wage price spirals of the 1970s and 1980s resulted in high unemployment and emigration. In addition, this trend could worsen the impact of an external shock to the economy, such as a sharp depreciation of sterling against the euro or a sharp fall in the US stock market.

Private sector credit is now rising at a rate of 25% year-on-year. The overall stock of credit has been rising to the point where it is now roughly at the European average. This growth reflects confidence in the economy, strong growth and low interest rates. Residential and commercial property prices have accelerated at an alarming rate. Property prices, as a percentage of disposable income, are now at historically high levels. In the context of the concern about housing costs, there have been calls for restrictions on credit growth. There is no authority to impose restrictions as we might wish. The Central Bank contribution is to ensure that the lending institutions have made good provisions for the rainy day. In the past year the Bank has put emphasis on stress testing and we have advised the banks repeatedly to pay strict attention to risk management. We remain uneasy about the continuing upward spiral in property prices; apart from other considerations, this generates an inflation mentality. The recent initiatives on housing taken by Government are to be welcomed.

I said earlier that the present rate of growth cannot be sustained. The Central Bank estimates that the economy could, however, sustain a growth rate of the order of 4½-5%, which is impressive by any standard. It may be feasible to maintain exceptional growth for quite some time ahead through importing labour. In view of the existing congestion levels in urban centres and the acceleration in accommodation costs, it is questionable whether our infrastructure can cope with this. Besides, the longer the surge in growth, the greater the downside risks. A slowdown is inevitable in time. This can - and I expect that it will be - achieved in a smooth and orderly manner, provided there is wage and price restraint. A smooth transition will require careful management; it may involve some erosion of our competitive position vis-à-vis our main trading partners and the objective must be to minimise this.

The Irish economy is one of the most open economies in the world. Last year, total trade - total exports and imports of goods and services - amounted to around 160% of GDP and this figure is expected to rise this year. Expressed as a percentage of GNP, this figure would be even higher. Because of this, developments in relation to competitiveness are particularly important for the Irish economy.

Supervision

May I now turn briefly to another aspect of the Central Bank's activities, namely the supervision of financial institutions. The number of financial entities that we supervise at present is of the order of 1,000. This includes 80 credit institutions, 600 investment intermediaries and 260 entities in the International Financial Services Centre. On top of this, we police about 2,000 funds in the Centre. There is legislation before the Oireachtas at the moment providing for the transfer of responsibility for insurance intermediaries to the Bank. We are preparing for this transfer; I understand that the Bank will assume responsibility for up to 6,000 such intermediaries.

In Europe, there is a gathering debate about the role of the Eurosystem in the supervision of the financial system. While the ESCB has a general involvement in supervision under the Maastricht Treaty, it does not have a day-to-day role. There is a potential for a more direct supervisory role under the Treaty but this would require a Council of Ministers decision. There is now a recognised gap in the system as there is nobody directly responsible for financial stability at euro area level. This debate is only beginning and I would be engaging in speculation if I went further on this subject. We are likely to see the emergence in due course of some European or euro area dimension to supervision.

The Irish financial industry continues to grow successfully. The priority for the Central Bank is to provide a regulatory service for this industry that matches the best international standards. I believe that we are doing so. I believe that, in general, our financial industry is now strongly compliant. Unacceptable practices of earlier years, relating to taxation, have damaged the reputation of the industry. There is now an awareness and an acceptance, at senior management and board levels, of the need for greater emphasis on the proper conduct of affairs.

It is important to appreciate the contribution which this industry makes to the Irish economy. About 45,000 people are employed in financial services here. These services now account for about 7% of

GDP. The contribution from the International Financial Services Centre alone to the Irish economy is estimated in the region of £1 billion. These are big figures.

The financial services industry is going through a period of great change. This is due to a combination of factors, notably new technology and cross-border activity. Technology does not respect national boundaries and it is changing the whole environment. The latest phenomenon is internet banking which introduces new challenges for the regulator who must ensure that the interests of customers are safeguarded. Financial institutions are concerned that there be clarity from a legal and regulatory perspective. The Central Bank has adopted a very positive approach towards the use of the internet as a medium to provide services; a number of applications for licence or authorisation are being considered. Our local industry is under threat from centralisation within the European Union as the financial markets become more integrated. Investors have a preference for larger markets with greater liquidity. Up to 30 banks from the European Economic Area are now branching into Ireland. We cannot entirely dismiss the prospect that within a few years the Irish market could be dominated by foreign owned banks. Competition is growing more intense; there is a price to be paid and this is perhaps reflected in the recent closures of local branches which can no longer be subsidised. The Irish banks must be cost efficient in order to maintain their position.

This is the background against which the regulator must operate. A high level of professionalism is demanded. We must aspire to having the highest standards of regulation. We must keep pace with international developments and much is happening internationally.

General

In conclusion, may I draw attention to some figures in the Annual Report and Accounts of the Central Bank for 1999. The Bank’s profits from its operations during 1999 were €248 million. Of this, €213 million is transferred to the Exchequer. At the end of last year, the Bank reserves were in the region of €1.4 billion. The numbers employed last year totalled approximately 650 of whom about 140 worked on supervision. Full details of all our activities are given in the Annual Report; I recommend this to the Committee.