John Hurley: Central bank cooperation – Ireland and Croatia

Speech by Mr John Hurley, Governor of the Central Bank and Financial Services Authority of Ireland, in response to Dr Ante Èièin-Šain Lecture, hosted by the Irish Croatian Business Association, Dublin, 29 September 2006.

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Introduction

It gives me great pleasure to speak to you this evening and to respond to what was a very interesting speech by Dr. Èièin-Šain**.** I see this evening as indicative of excellent relations between Ireland and Croatia in business, financial and political circles. I am also pleased to see some familiar faces from a dinner that I hosted in 2002 for this association. I cannot say, however, that that my experience of central banking has included quite so many immediate and intense challenges as that of Dr. Èièin-Šain*,* no matter what one might think goes on during meetings in Frankfurt.

Ireland and Croatia have a good deal in common, not least due to the fact that both have been occupied for centuries as part of much greater empires but have evolved into small, independent countries. And I can fully understand the sense of regret among Croatians for the years that you spent cut off from Western Europe. I very much look forward to the day when Croatia takes its rightful place in the EU**.**

Many of you will be aware of a rather special link between Croatia and our own central bank. As you know, your Prime Minister, Mr Sanader*,* and our Taoiseach, Mr Ahern, announced last year that our two central banks would cooperate in issuing collector coins to commemorate the work of Croatian sculptor, Ivan Mestrovic. Mr Mestrovic submitted a design for the first coinage of the Irish Free State in 1927. Unfortunately, because of difficulty contacting him – he was in the United States - his design arrived too late for consideration. The Chairman of the Design Committee, Irish poet William Butler Yeats, subsequently wrote "He made one magnificent design and, on discovering that the date had passed, gave it to the Irish Free State with great generosity". We hope to launch this coin set in early 2007 and it already promises to be a very popular collector's item.

Looking at our respective central banking histories, it is clear that Croatia had to take a remarkable number of steps in a very short space of time and, moreover, in a very hostile environment. I cannot speak highly enough of the role that you Dr. Èièin-Šain and others played and the Croatian nation is in your debt. When our country became independent of the United Kingdom in 1922, we had the distinct advantage that there was already a well-developed banking system. Given the upheavals of the years following independence, a cautious approach was taken. It was generally acknowledged that the new State needed a distinctive currency. But with a very important proviso, that it should command no less confidence than sterling, which had been the currency of Ireland since 1826. The first Irish coins were issued in 1928 and on a fixed parity with sterling. The Currency Commission was then established in 1927, essentially to issue currency and develop money and banking statistics. The Central Bank only came into being in 1943, gradually gaining most of the powers normally associated with central banks over the following 30 years.

I am conscious that this pace of progress contrasts greatly with what we have heard about the Croatian experience. We might wonder why the authorities at the time were not more determined to achieve monetary independence but the link with sterling was largely unquestioned. This reflected a high degree of trade integration and capital and labour mobility with the UK. In a world of fixed exchange rates, the sterling link served us well until the breakdown of the Bretton Woods arrangements in the early 1970s.

With the move to generalised floating that occurred at this time, the appropriateness of the link to sterling came to be questioned. Persistently high inflation rates in the UK coupled with a significant depreciation of sterling fed through the exchange rate link to similarly high inflation rates in Ireland. The establishment of the European Monetary System (EMS) – with its primary objective of being a 'zone of monetary stability' – offered us the opportunity of importing lower inflation from the more inflation-averse core EU countries. Ireland joined the EMS at its inception in 1979, ending the link with sterling.

Our experience in the EMS in the early years was not always positive. In particular, the pursuit of pro-cyclical policies undermined stability and we were forced to devalue on a number of occasions. In the late 1980s, fiscal policy was put on a sound footing and the inconsistency between the stance of domestic policy and the exchange rate objective was resolved. This in turn laid the groundwork for much of the economic advancement that was to follow.

Having said this, there is no single reason why the Irish economic story turned around so dramatically between the mid-1980s and the mid-1990s. The main lesson from our own experience is the importance of features such as sound macroeconomic policies, a strong commitment to free trade, a lightly-regulated competitive business environment and a well-educated and flexible labour force. However, some reasons are not ones that can be copied – for example, the benefits of being an English-speaking nation with close ties to the US business community through the Irish-American diaspora.

It is difficult to overstate the importance of education. Indeed, many commentators see the decision to make second level education free in 1969 as key, since it produced a pool of well-educated workers by the mid-1980s. This, however, needs to go hand-in-hand with openness to foreign investment – without this, educated workers will simply move to firms abroad rather than the firms moving to them. An active industrial policy can also help, as firms tend to cluster in industrial groups so as to achieve economies of scale in supplies etc. For example, Ireland actively targeted major IT firms in the 1980s and early 1990s, which has seen a cluster of such IT firms just outside Dublin. Once some major firms set up operations, it was much easier to attract smaller firms in the same industry.

This emphasis on openness to foreign investment allows me to pick up on the issue of national sovereignty that Dr. Èièin-Šain mentioned. Ireland adopted predominantly protectionist and inward-looking policies in the first 35 years of the State's existence. Notwithstanding the small domestic market, the emphasis of development policy was on promoting domestic industry behind high tariff barriers. Not surprisingly, these policies were not successful in delivering sustained economic growth and higher living standards. Employment failed to increase and emigration rose to very high levels. The legacy of protectionist policies was a small and inefficient indigenous sector, which primarily served the domestic market.

The failure of protectionism and over-reliance on agriculture were recognised in the late 1950s and, over the course of the following two decades, the economy was opened up to trade and investment. In particular, the focus shifted to attracting high-productivity export-oriented foreign industries, a policy which has been remarkably successful in generating economic growth and prosperity over the past 40 years. There have also been significant spin-offs in terms of servicing and supplying foreign firms, which has contributed to the development of the domestic services sector. Our success in generating employment, however, has been a more recent development and reflects the fruits of the increased emphasis on education, a reduction in the labour market disincentives which prevailed up to the late 1980s, and the benefits of a light degree of regulation of labour and product markets.

With regard to other important factors in our economic success, I would also like to emphasise the role of institutional factors. The rigorous and just enforcement of law is a basic requirement for investment while administration needs to be efficient, with regulations assessed on a cost-benefit basis. Indeed, I believe that over-regulation plays a key role in stifling enterprise. Unlike many other structural reforms, improvements can be made in this area often with little social cost.

A national consensus on the way forward is also important and the social partnership model has served Ireland very well. This allows firms and unions to take account of the national interest in a way that they could not be expected to do if they each acted alone. And, by and large, union members and employers have ratified national agreements negotiated by their umbrella groups.

Development of infrastructure is also very important. I know from my days in the Department of Finance that capital spending tends to be a vulnerable part of any budgetary process, as the impact of current spending is usually more immediate. This is where EU structural funds can be of particular benefit, since they normally require co-funding from the national budget. Once this funding is made available, the returns to the economy are immense as the national taxpayer pays only part of the costs but reaps all the benefits. The EU is, of course, very anxious to see that its money is being spent wisely and criteria for project assessment are rigorous. Yet it is essential to maximise the full potential from structural funds and I am delighted that Ireland is providing practical advice from our many years of experience.

I emphasise these factors as I feel that they may have some relevance to Croatia today. When I look at the Croatian economy, however, I am struck by the extent of progress to date. The changeover to a market economy has been remarkable. Economic growth has been robust, particularly since 2000, and has recovered well from the banking crisis of 1998 and 1999. The achievement of price stability also deserves special mention, as headline inflation was close to just 2 per cent in the period 2002 to 2004 before rising largely due to energy and food prices. This is testament to the success in achieving a high degree of stability in the exchange rate of the kuna against the euro.

On the financial side, the privatisation process in banking has led to a huge inflow of foreign investment and expertise and created a stable and efficient banking system. Today, banks in Croatia are profitable and capital adequacy ratios are well above requirements. This is fostering the development of financial intermediation in the wider economy though, thankfully, credit growth has not reached the exceptionally high rates seen elsewhere in Central and Eastern Europe. Administrative measures undertaken by the central bank to dampen credit growth appear to have had some impact. But it has been our experience that that these are circumvented over time and should be seen as buying time for fiscal policy to play a greater role in macroeconomic adjustment.

I hope that I have provided some food for thought on economic development. I would like to end by emphasising that Ireland firmly supports Croatia's objective to become a member of the EU and were delighted to see the start of accession negotiations last year. Croatia can also act as a positive example to other countries in the region in terms of the willingness of the EU to help countries develop towards participation in European integration. I look forward to the day when Croatia becomes a member of the EU.