

**MONEY AND BANKING IN IRELAND  
ORIGINS DEVELOPMENT AND FUTURE†**

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**INTRODUCTION**

Currency and banking have a relatively long tradition in Ireland. Coins have circulated for about 1,000 years and banking has been practised for some 300 years. Significant financial change was a feature of earlier periods as it has been over the past twenty five years. Current indications are that the rate of structural change in the financial sector will gain momentum between now and the end of this century. An appreciation of the past can contribute to understanding the present. Influence over future events can be improved by a greater awareness of how we adapted to change in the past. With this in mind, a brief review of the evolution of currency and banking in Ireland, both in the Republic and Northern Ireland, is presented here together with a preview of some of the major changes that will be occurring in the decades ahead. The emphasis is on the structural changes that occurred rather than an evaluation of the policies pursued but many of the issues raised are relevant to the debate about the expected changes in the financial sector in the 1990s. A wide range of publications on Irish banking has been drawn upon, many of which are cited in the Bibliography.

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The review is divided into three parts. Part I concentrates on the historical background and outlines the origins and development of money and banking in Ireland up to the middle of this century. Part II concentrates on the significant changes in banking and other financial institutions that have occurred in Ireland in recent decades, including the 1980s. Finally, Part III looks towards the twenty first century and integration within Europe with the emphasis on prudential supervision of banks, other financial institutions and the capital markets.

## **PART I: THE ORIGINS**

### **Coinage**

Coins began to be used extensively throughout Europe with the re-emergence of exchange after the Dark Ages. They were first issued in Ireland by the Norse Settlement in Dublin during the 990s, many centuries later than in other European countries, including England, Wales and Scotland. In the next two centuries, the acceptance of the use of coinage was relatively slow. The absence of the use of coins in Ireland before this may reflect the existence in Ireland over the previous millennium of a relatively highly developed but localised legal code and counting arrangements that accommodated trading and exchange. With the arrival of the Normans in 1169, issues of Irish coins were made more frequently and this continued for some three centuries up to around 1500. However, from about that time, the minting of coins in Ireland was discouraged by the monarchy.

The circulation of coins, which was probably centred on the ports and other major towns, existed side by side with barter for at least 700 years until after the emergence of banking-type activities in the 1680s. From then onwards, barter began to recede more rapidly and the currency notes issued by private bankers, which were for uneven amounts, began to form an increasing but small part of the growing currency circulation. Gold coins rather than silver probably played a greater role from 1717 onwards when Sir Isaac Newton – then master of the mint in England – mistakenly over valued gold relative to silver by setting the official price of the gold guinea, in terms of silver, at twenty one shillings.

The design and availability of the coinage from around 1500 up to about 1600 was very unsatisfactory. Irish coins tended to percolate abroad for many reasons – trading, movement of troops, discharge of royal levies, and contributions towards financing wars in which England participated. Outflows of Irish-minted coins tended to be replaced and augmented by 'Irish' coins of a relatively inferior content that were provided from England to pay for Irish raw materials and the financing of Crown activities, including garrisons, in Ireland. Apart from the minting of 'money of necessity' by the monarchy from time to time, no major Irish mints existed from about 1500, and there were royal prohibitions from the time of Henry VII on transporting to Ireland the more valuable English coins that were intended for circulation in England. Apart from Irish and English coins, there was an appreciable circulation during the sixteenth century of continental coins, especially Spanish, which became more abundant as the century drew to a close when the Spanish dollar reigned supreme internationally.

Over the next two centuries, that is, from 1600 to 1800, there was an improvement in the condition of the coinage. Despite the royal prohibitions, high quality English coins found their way into circulation in Ireland especially after the introduction of the gold guinea in England in 1663. Attractive coins of other European nations – Spanish, Portuguese but also French – continued to percolate into circulation. Such developments helped to meet the demands for currency and, in addition, in the eighteenth century many merchants issued their own tokens in substitution for coinage to facilitate trade.

There are some suggestions that the coins issued in Dublin in the tenth century were similar to those in circulation in other Norse settlements in Europe at that time. We know, however, that as far back as 1200, Irish and English silver coins were interchangeable at par in Ireland and that this situation continued for the next 250 years or so. This was because both sets of coins, though different in design – the Irish having a distinctive triangle – were similar in size and silver content. In 1460 steps were taken to increase the supply of coinage by devaluing or reducing the silver content of the existing Irish coins. In those days, devaluation was a major technical undertaking in the sense that existing coins had to be withdrawn and melted down and restruck into a larger number of new coins of smaller silver content. The devaluation of 1460 drove a wedge between the Irish and English coins as they no longer contained a similar amount of silver and, from that time onwards, the Irish currency was independently recognised in the course of commerce and trade. By 1487, that is 500 years ago, the exchange rate had depreciated to one and a half Irish to one English, at which level it seems to have more or less remained until it was depreciated further in the 1550s.

The coinage was debased or devalued on a number of occasions in the 1500s – at the time of the Geraldine Rebellion of 1534–35, in the decade up to 1561, and at the end of Elizabeth's reign – with a view to contributing towards defraying the relatively heavy expenses that the English monarchy incurred in Ireland. In other words, devaluation was regarded as a substitute in time of war for collecting taxes and levies. It was during the time of one of these monetary disturbances, probably in 1536, that Henry VIII formally recognised the Irish pound as a unit of account and introduced the harp coinage into circulation. In 1601, Elizabeth I introduced copper coinage. The minting of coins was made the prerogative of the monarchy and, despite transport costs, was mainly conducted in England presumably to give the monarchy maximum control over the introduction of new coins into circulation in Ireland. After depreciating in the 1550s, the exchange rate appreciated in 1561 to one and one third Irish to one English. It remained at around that level for forty years until the 1601–1603 period, when there was monetary chaos and a marked depreciation, to close on four Irish to one English.

After 1603 the exchange rate appreciated again to much the same level as in the closing decades of the previous century namely, one and one third Irish to one English. At the time of Cromwell, however, that is in the 1650s, a one-for-one parity seems to have been established. After 1660, this was followed by a depreciation of up to 8 per cent in the Irish exchange rate.

As already mentioned, the coinage that was specifically provided by the monarchy for circulation in Ireland during the seventeenth century was supplemented with a growing mixture of English and continental coins of higher value. The external coins of relatively higher value were retained in Ireland in preference to the relatively low quality coinage provided from England for circulation in Ireland. Eventually, following the striking of 'gunmoney' by James II (from copper and bronze extracted by melting down cannon, which has left us with the phrase 'not worth a brass farthing'), a reform of the Irish coinage was conducted in 1689. This resulted in the re-establishment of the Irish currency at a fixed par of exchange of thirteen Irish pence for twelve English pence. This par of exchange, which was to prevail without interruption for over a hundred years, appears to have been based on the silver content of the international mixture of coins circulating in Ireland relative to that of the coins circulating in England. Europe may have been closer to being a single monetary area in those days than in any period since then.

The value of the diversified coinage in circulation increased over the eighteenth century from about £0.5 million in the 1720s to over £1.0 million some fifty years later. Nevertheless, a distinct shortage of well-designed coins continued to prevail throughout the eighteenth century – a phenomenon observable in a number of European countries too. Despite the need for an adequate supply of currency, a patent issued to a Mr. Wood in the 1720s, which would have rapidly

increased the circulation of copper coinage in Ireland by about 25 per cent, was withdrawn within two years of being granted. This was because of a campaign waged by Jonathan Swift in *The Drapier's Letters* about the inflationary implications of introducing into circulation what has since been known as Wood's half-pence. No noteworthy changes in the composition or condition of the coinage were to occur over the eighteenth century other than the increasing inflows of gold coins from England especially in the 1790s.

Major changes were introduced in Britain in the opening decades of the nineteenth century. The gold sovereign was established by the Coinage Act of 1816 and replaced the guinea which had been the main gold coin since 1663. Newly designed silver coins, which were not as valuable as the sovereign, were also introduced into circulation. The commitment to monetary stability following the currency upheavals of the Napoleonic era, the laying of the foundations of the sterling area throughout the British colonies and overseas possessions, and the amalgamation of the Irish and British currencies in 1826, opened the way for the introduction of the recently designed and reformed British currency into widespread circulation in Ireland.

From then onwards the quality of the coinage was of a high standard and the demand for coinage, including sovereigns and half sovereigns, was fully met by an increase in the circulation of British currency in Ireland. Although sovereigns were the only form of legal tender in Ireland in the nineteenth century, the amount in circulation did not keep pace with the growth in bank deposits. Furthermore, as part of the arrangements for financing World War I, sovereigns ceased to be issued by the banks and were replaced mainly by Irish bank notes which were temporarily extended legal tender status over the period 1914 to 1919. So in the early 1920s the coinage in active circulation consisted solely of British silver and copper coins.

This situation existed until December 1928 when the Irish government launched a distinctive Irish silver and copper coinage, recommended by a committee under the chairmanship of W.B. Yeats, in substitution for the British coins in circulation. Arrangements were also made for the gradual repatriation of British coinage as it was withdrawn from circulation. Some modifications have been made to the metal content of the Irish coinage from time to time and a newly-designed Irish coinage was introduced in 1971 when the decimal currency system was adopted. However, it was not until Ireland joined the European Monetary System – some fifty years after the Irish coinage was introduced into circulation – that the decisive conditions were created by the break in the fixed link with sterling which led to the virtual disappearance of British currency from circulation in Ireland in the early 1980s. However, almost all the coins in Northern Ireland continue to be British as has been the situation since 1826. The design, size, weight and metal content of the coinage in the Republic will be modified in the

first half of the 1990s with the introduction of a one pound coin<sup>1</sup> and the replacement of the existing series with a more convenient coinage.

### **Private Banking: 1700s**

Irish banking cannot claim direct links with the Italian banking dynasties of the thirteenth century. Nevertheless, it can be traced back to the 1680s when currency notes were introduced in Ireland alongside the circulation of coins. That was the time when the foundations for the rise in confidence and economic prosperity of the eighteenth century were being laid. Initially the currency notes took the form of receipts issued by goldsmiths, coin exchangers and merchants located in Dublin and other major ports who acted as managers and custodians of coins on behalf of their owners or savers. It was the emergence of the practice of making payments by transfer of the goldsmiths' receipts, rather than withdrawing the coins themselves to effect the payments, that conferred the status of money or medium of exchange on these receipts and led to them being described as currency notes. The value of such notes in circulation rose from about £0.5 million in the 1720s to around £1.0 million in the 1750s – a level that was not exceeded again until the 1780s.

The essential features of modern banking began to emerge in Ireland from the late seventeenth century onwards. Apart from the custodial features of early banking, referred to above, it was recognised in the early eighteenth century that the custodians of gold coins and valuables also had the ability to engage in lending. They could lend provided they retained the confidence of those who deposited the gold coins with them. As long as the receipts for the gold deposited continued to circulate for the purposes of effecting payments and were not presented for conversion into gold coins, the custodians of such coins, whether goldsmiths or merchants, could issue receipts made out to bearer in excess of their coin holdings. Up to a point, the excess issues of receipts helped to maintain the amount of money in circulation as only a certain proportion of the receipts issued in respect of the deposits of gold freely circulated as money.

As the self confidence of the goldsmiths grew and their lending began to exceed their holdings of gold coins they became engaged in creating credit, that is, adding to the overall supply of means of payments or money in circulation as a result of granting credit to borrowers. The evolution of this practice by goldsmiths and merchants helped to finance investment and maintain the level of spending. However, it also exposed the economy and society to the risks of excessive credit creation and the collapse of banking institutions. The collapse of a bank could easily arise as a result of the rapid conversion of currency notes into gold coins that outstretched the capacity of the bank to continue converting its loans into gold coins. The failure of a bank could also arise as a result of imprudent lending that could not be recovered, thereby resulting in the writing

off of the bank's capital and the erosion of its capacity to repay its deposits in full.

Over the period 1700 to 1750, Irish banking was highly innovative by the international standards of the time which were being set in Scotland. This was the era when private banking flourished and it was not until the early decades of the next century that private joint stock banks, the forerunners of the present-day clearing banks, emerged. By 1750 there were banks in some eight centres throughout Ireland whose main business was as follows: the banks provided credit to merchants by issuing currency notes to them which enabled the merchants to purchase grain, etc., from farmers especially for export. Subsequently, the farmers used the notes to pay their rents to the landlords. Then the landlords exchanged the notes for the foreign proceeds of the exports that had been lodged by the merchants to discharge their original borrowings from the banks. The landlords then used the foreign currency to pay for imports and finance consumption and investment abroad. Seasonal requirements, therefore, had a significant influence on the business of banking in Ireland down the centuries until recent decades.

Banking in Ireland in the eighteenth century was associated to a significant extent with the interests of the landed aristocracy unlike in other Western European countries where it was based primarily on the needs of the emerging merchant classes and of the state. The Irish banks were primarily concerned with facilitating the transfer of agricultural output from the countryside to Dublin and abroad and placing the proceeds of the sale of that output at the disposal of the landlords. However, around mid-century, a number of banks that became actively engaged in supporting the growing needs of the merchant classes collapsed in the wake of disappointing economic circumstances, strained liquidity conditions and accompanying bad debt experiences.

This led to legislation in 1756 which excluded merchants involved in foreign trade from engaging in the business of banking. As a result, a division between banking and commerce was instituted that even today is carefully guarded in many developed countries. One of the main outcomes of this was to strengthen the influence of the landed gentry. Consequently, private banking in the second half of the 1700s failed to display the highly innovative character of its earlier years, despite more favourable economic circumstances, and did not keep abreast of developments in Scottish banking. The last expansionary but short-lived phase of private banking occurred during the Napoleonic Wars.

Irish banking, following the liberal expansion of private banks after 1790, was not well prepared for adapting itself to the economic depression that emerged after the 1798 Rebellion in Ireland and the Napoleonic Wars on the continent. It relied too much on land as security, lacked a dynamic commercial influence and was

overstretched following the exceptionally large increases in currency during the war years. Consequently, a number of private bank failures were again experienced between the closing years of the 1790s and the early 1820s. By the 1890s, all of the private banks that survived had been integrated with the joint stock banks established from 1824 onwards.

The savings bank movement, which had its origins in Scotland, was launched in Ireland around 1815 when the first savings bank was started in the parish of Stillorgan, Dublin. By 1820, all of the trustee savings banks now in operation throughout Ireland had been established. Furthermore, within a few years, i.e., by the mid-1820s, an important phase in the development of Irish banking was to begin with the establishment of reasonably widely-owned joint stock banks with unlimited shareholder liability.

With the introduction of joint stock banking, a reasonably firm foundation was set in a remarkably short number of years – between 1824 and 1836 – for the existing clearing bank system. This was achieved despite a short-lived but reasonably serious run on existing banks in 1836 in connection with declining confidence in the adventurous Agricultural and Commercial Bank of Ireland. This joint stock bank, which opened its first branch in Nenagh, Co. Tipperary, in 1834, collapsed without loss to its note holders and depositors but at the expense of its shareholders. It failed because of lack of planning and foresight by the promoters, shareholders of limited means, unsuitable management and staff, misappropriation of funds, reckless lending and record keeping that did not keep track of the amount of currency notes that were put into circulation mainly on a commission basis.

### **Central Banking: First Steps**

Most national or central banks were established or evolved because of the financial needs of the state, especially in time of war. The first of those types of banks that eventually became central banks was established in Sweden in 1668. In England, what is nowadays known as a central bank came into being when the Bank of England was established in 1694. There was a similar intent in Scotland when the Bank of Scotland was established in 1695. However, an initiative by the main merchants of Dublin in 1695 to establish 'a public bank or a fund of credit for the encouragement of trade, and supply of the present want of money' faltered. There was no enthusiasm for such a development in Ireland in the late 1690s and early 1700s owing to concern about what was felt to be the excessive influence of the English monarchy on Irish affairs. Neither was there a crisis in the public finances or serious instability in the banking system – the two main reasons for the emergence of central banks.

The lack of enthusiasm in Ireland towards extending power and privileges over financial matters to the monarchy was partly fostered by Jonathan Swift – who



did not hold bankers in high esteem – in The Drapier's Letters. However, in 1721, a charter for a national bank similar to the Bank of England was granted subject to approval by Irish parliamentarians. Because of the absence of political support and also because of mistrust in the 1720s of all financial innovation after the South Sea Bubble, the charter did not receive the support of the Irish politicians. Consequently, the emergence of national banking was postponed for over sixty years. In the intervening period, the Irish philosopher and economist George Berkeley contributed to keeping the issue alive by making a case for a national bank for Ireland in 'The Querist' published in 1735.

Conditions changed – markedly so in the second half of the eighteenth century – in favour of promoting a national bank. This was partly as a result of the adverse private banking experiences around the mid century. More important was the indirect impact on the Irish economy and public finances of the international economic disturbances associated with the American War of Independence. Against this background, the deficits in the Irish public finances, which had persisted from the early 1760s, had become more pronounced in the late 1770s and early 1780s leading to relatively substantial increases in borrowings by the Irish Exchequer. This gave a major stimulus to the re-opening of the case for a national bank. These financial developments, together with the spirit of independence kindled in Ireland through contact with continental Europe but particularly in the light of the American Declaration of Independence in 1776, generated the political support which was previously lacking for the services of a national bank. The first faltering steps were taken towards promoting what is nowadays regarded as a central bank when, in 1783, the Bank of Ireland – now a clearing bank – was established by the Irish Parliament.

The management of the Exchequer Accounts together with the Registers of Government Stocks were entrusted to the Bank of Ireland. In turn, the bank advanced most of the proceeds of its newly-issued capital to the Irish Exchequer which, within a decade or so, also extended its borrowings to England in the aftermath of the declaration of war on France by England in 1793. There was a ceiling of 5 per cent on the rate of interest that the Bank of Ireland could apply to lending. For the next forty years or so, the Bank of Ireland was the dominant influence in the banking system even though it had no branches outside Dublin until the mid 1820s. It was not exposed to serious competition and accounted for a major share of the note issue, especially in the decade 1815 to 1825, as it was the only large bank, that is, with more than six shareholders, that was permitted to issue notes throughout the country. However, the Bank of Ireland was not destined to evolve into what is nowadays known as a central bank although it continued to develop decisively in this direction up to about 1850.

With the transfer of the seat of government from Dublin to London, following the coming into effect of the Act of Union on 1 January 1801, the management of the financing of the state shifted from Dublin to London. This limited the role that the Bank of Ireland could play in the early decades of the nineteenth century especially in the period following the amalgamation of the British and Irish Exchequers and Public Debts in 1817. Further constraints were placed on the Bank of Ireland in the second half of the last century with the passage of the Bankers (Ireland) Act 1845, with the emergence of the international gold standard and the establishment of the Bank of England as the lender of last resort for the whole of the sterling area, including Ireland.

Up to the middle of the last century the Bank of Ireland acted in a limited way as a bankers' bank and as a hesitant lender of last resort, though it provided in central bank like fashion strong leadership in establishing currency note and cheque clearings arrangements between the banks. When joint stock banking was on the horizon, the Bank of Ireland pressed hard in the early 1820s to preserve its dominant position especially in relation to the issue of currency notes which, after 1821, was confined to a radius of sixty five miles from Dublin. It was reluctant to accept the emergence of joint stock banks although it did compete directly with them throughout the country particularly from the mid 1820s onwards. When the Bankers (Ireland) Act 1845 was passed, the remaining privileges of the Bank of Ireland in relation to the issue of notes in the Dublin region were removed by allowing the note issuing joint stock banks in existence at that time to issue their notes in the Dublin region. All note issuing banks could issue freely their notes throughout the country after 1845.

Apart from providing for more effective competition between banks, the 1845 legislation was designed to discourage increases in the circulation of private bank notes from displacing gold and silver and eventually Bank of England notes from circulation. A domestic policy of substituting the note issue of the Bank of England for that of the other banks was being firmly implemented in Britain in the mid 1840s. It had also been an objective of British foreign policy since the 1820s to directly or indirectly promote the circulation of British currency throughout the British Empire. Against this background, the emergence in Ireland in the 1840s of an institution similar to the Bank of England, with a monopoly of the note issue, was probably not being encouraged. Nevertheless, it is of interest to recall that some forty years later the Chancellor of the Exchequer reminded the Bank of Ireland of its special position among banks in Ireland at the height of the Munster Bank crisis in 1885. At the time of the 1845 legislation, the Bank of Ireland was given the sole right of handling the government's cash operations. In addition, the ceiling on the rate of interest it could charge on loans was abolished – a step that had no impact on the Irish public finances which were integrated into the British Exchequer some twenty eight years earlier.

These legislative changes placed all banks on a more or less equal footing and created conditions which enabled the Bank of Ireland to concentrate to a greater extent than heretofore on commercial banking. A further boost to the Bank of Ireland's commercial role occurred in 1855 when it sanctioned the use of overdrafts, and in 1864, when it commenced paying interest on deposits and was granted the power to extend credit, secured by mortgage. The increasing competitiveness of the Bank of Ireland probably encouraged its competitors to rely less on it for temporary support or accommodation. From the 1860s onwards, similar services were readily available in London to the other banks from institutions that they did not regard as major direct competitors, thus weakening the leadership of the Bank of Ireland.

By the time independence was re-established in the 1920s, the Bank of Ireland had developed primarily along commercial lines and was not destined to evolve towards central banking in the recently established state. A serious conflict of interest would have arisen if the primary functions of a central bank were to be vested in a competitive profit-oriented bank that was part of the private sector, as international experience with the evolution of central banking in the nineteenth century had clearly demonstrated. There was also increasing international recognition in the 1920s, following the establishment of the Federal Reserve System in the US just before the outbreak of World War I and the inflationary experiences in Europe in the aftermath of World War I, of the desirability of maintaining central banking independent of the authorities.

These international concerns received support in Ireland in the 1920s through the reluctance of the existing banks to become closely associated with extending financial support to the newly-established authorities in Ireland. At the same time, however, the banks were not enthusiastic about losing their right to issue currency notes to an embryonic central bank. Indeed, it could be said that the banks were not receptive to the idea of establishing a central bank – a point of view that was expressed on a number of occasions up to the early 1940s. This echoed the resistance of commercial banks in other countries during the nineteenth century to central banks' acquiring a monopoly of the note issue and extending their influence over the banking system. It was against this conservative background in monetary matters that the forerunner of the Central Bank of Ireland, namely the Currency Commission, was established in 1927 and that central banking evolved in subsequent decades.

### **Monetary Instability: Early Experiences**

The wars in Europe between 1793 and 1815 and the implementation of the Act of Union had significant implications for deficits in the public finances, banking, the currency and the exchange rate. After the British declaration of war on France in 1793, the Bank of Ireland became engaged in financing part of the large increase in military expenditure which was outstripping revenue receipts.

Within a decade or so of being established, the Bank of Ireland was also engaging in excessive increases in lending and issues of bank notes to the private sector. Military spending increased substantially after 1794 and led to a substantial increase in the public debt over the twenty-year period 1795 to 1815.

In the decade 1794 to 1804, there was a five fold increase in the amount of Bank of Ireland notes in circulation – from £0.5 million in 1794 to some £2.5 million in 1804. Most of this increase occurred between 1798 and 1803 when the Irish pound was floating against sterling, gold and, of course, the continental currencies that remained tied to gold. Both the long-established and recently-launched private banks, of which there were over forty in operation outside Dublin in 1804, were also engaging in excessive issues of currency notes during the closing years of the eighteenth century and the opening years of the nineteenth century; their note circulation peaked at a level of some £1.3 million around 1803 compared with around £1.0 million in the 1780s. However, the contribution of the private banks to the overall increase in the note circulation between 1798 and 1803 was overshadowed by that of the Bank of Ireland. It is appropriate to recall that the circulation of gold coinage, which may have amounted to £5 million in 1797, may have fallen from that relatively high level in the late 1790s and early 1800s.

Along with the large increases in the note circulation, there was also evidence of a change in the relationship between exports and imports. In the first year of each decade of the eighteenth century there is evidence that exports exceeded imports. But in the first year of each of the first two decades of the nineteenth century an excess of imports over exports is recorded despite the opportunities to increase Irish exports in war-time conditions.

The relatively large increases in the currency issue after 1793 together with the fall in the exchange rate between 1797 and 1804, referred to in the next paragraph, led to the appointment in 1804 of what may be regarded as the first ever official committee of inquiry – the Irish Currency Committee – into the relationship between credit creation, currency issues, prices, external payments and the exchange rate in a small open economy. However, little attention was given by the committee to the monetary and exchange rate implications of the relatively large fiscal deficits that were being incurred to finance military expenditure. Moreover, there was little consideration of the extent to which the increase in the notes in circulation may have been to replace gold coins.

It was not surprising, following the floating in 1797 of both the Irish pound and sterling against gold, and the relatively large increase in the Irish currency circulation, that the Irish pound experienced sharp fluctuations vis-à-vis sterling which was also floating against all other currencies, including the continental

currencies that continued to be underpinned by gold. The Irish pound devalued vis-a-vis sterling by some 10 per cent between 1797 and 1804, then appreciated up to 1813 and subsequently devalued sharply so that by 1815 it had reverted to much the same level as in 1804. The floating exchange rate arrangements continued until 1821 when both sterling and the Irish pound were again fixed to gold at the same relationship of thirteen Irish pounds to twelve pounds sterling that had prevailed in 1797.

This consolidated the 10 per cent appreciation of the Irish pound against sterling that occurred between 1815 and 1821. It is appropriate to recall that it was during this period – in 1817 – that the Irish Exchequer and Public Debt were effectively integrated with the British Exchequer and Public Debt. This fiscal development may have made a contribution to the re-establishment of the exchange rate at its 1797 level and to diverting attention from the implications of the outstanding external debt vis-a-vis Britain which had continued to increase between 1798 and 1815.

It is not surprising that after the Battle of Waterloo in 1815, there was a period of severe economic contraction and falling prices in Ireland, which contrasted with the improvement in economic conditions and inflation that prevailed between 1793 and 1815. The following three factors contributed to the economic depression although the extent to which each did so is not clear: the indirect impact of the international depression following the peace settlement at the Congress of Vienna in 1815; the spillover effects of the pursuit of the singularly British monetary objective of resuming the conversion of Bank of England notes into gold at the rate that prevailed in 1797, even though prices had risen substantially in the meantime; and the direct locally-created effects of the relatively tighter monetary conditions that seems to have been applied in Ireland.

It may be the case that the monetary restraint in Ireland was pursued with a view to preparing the way for the return to the fixed level of the exchange rate between the Irish pound and sterling that prevailed throughout the eighteenth century. It may also have been pursued to achieve the narrower banking objective of building up bank liquidity in anticipation of the possible presentation of outstanding bank notes that might follow the amalgamation of the Irish pound and sterling at parity. It is noteworthy in the context of the objectives of British foreign policy that the currencies were amalgamated on a one-for-one basis in 1826, just five years after the reintroduction of the fixed exchange rate. Apart from the thirteenth and early fourteenth century custom of exchanging Irish and English coins at par, this was the second occasion that the currencies were deliberately united at par (the first occurred under Cromwell in the 1650s and seems to have lasted for less than a decade).

The British currency circulated freely throughout Ireland until 1927 – six years after political independence – when the Irish pound was legally established. The

reinstated Irish pound was placed on a one-for-one no margins basis with sterling for the purposes of maximising confidence in it and avoiding any change in monetary conditions from what would have prevailed if sterling had continued to be the principal currency in circulation. This relationship between the Irish pound and sterling continued for over fifty years until 1979 when Ireland joined the European Monetary System and the link with sterling was broken again. However, the currencies are destined to be amalgamated again, but with other European currencies on the next occasion, when European Monetary Union eventually becomes a reality.

### **Monetary Integration with the Sterling Area**

Ireland had been on a de facto gold standard since 1717 except during the period of the first modern international monetary crisis, that is, the global monetary upheaval associated with the Napoleonic Wars. In 1821, Ireland was integrated into the British gold standard which in 1816 had been placed on a legal footing as part of the monetary reforms following the restoration of peace in 1815. Within fifty years, London had evolved to become the hub of the international monetary system – a position which it retained until 1914. During the last century the pace of economic development in the major economies did not lead to serious external imbalances or major confrontations.

The breakdown of the international gold standard followed in the wake of World War I and, from the 1920s, the US dollar and New York were at the centre of the international financial system. Following the acceptance of the gold standard in the 1820s, which minimised the discretionary role of the authorities in monetary affairs, the appropriateness of the gold standard arrangements was not seriously questioned until Keynes expressed serious reservations about Churchill's policy of revaluing sterling in 1925 to its 1914 level. Subsequently, sterling was devalued on a number of occasions – in 1931, 1939, 1949, 1967 and again during the period 1972 to 1976. During these major changes in international monetary arrangements, Ireland continued to remain a member of the sterling area, until it disintegrated after the devaluation of sterling in 1967, and to be directly linked with sterling itself until the European Monetary System came into operation in 1979.

With these rigid exchange rate connections it is probable that over time the magnitude of the increases and decreases in prices and interest rates in Ireland over the centuries (excluding the twenty-five year period 1797 to 1821 when movements in prices and interest rates in Ireland may have been more pronounced than in Britain) were of a similar order of magnitude to those experienced in Britain. It is also probable that, apart from short lags, the fluctuations in prices and interest rates occurred in both economies around the same time. However when there was a financial crises in London interest rate increases there were larger than those that followed in Ireland.

Relative stability in prices and interest rates, that is, relative to those in Britain rather than absolute price and interest rate stability is what resulted from being on the gold standard and a member of the sterling area. Thus, the growth in the currency circulation in Ireland was directly influenced by the relative stability of prices in Britain and the movements in interest rates there. Moreover, the growth in the currency circulation in Ireland also reflected the speed with which barter disappeared in Ireland, the rapid growth in deposit facilities throughout the country after the 1820s and especially the rate at which the Irish economy developed. Since the Irish economy did not grow as rapidly as the British economy, it is probable that the rate of growth of money in circulation in Ireland and indeed the rate of expansion of the banking system was much slower than in Britain (even if the substantial contribution of non-resident balances to the growth of the British banking system were excluded).

The increase over time in the amount of money in circulation and in bank deposits was sustained by the net impact of certain developments between Ireland and abroad. The net result of the money transactions between Ireland and the British Exchequer, plus the excess of domestic receipts from abroad<sup>2</sup> over domestic payments abroad<sup>3</sup>, provided the external base for the growth over the centuries in the amount of currency in circulation; and also provided the base for the rise in bank deposits, including those with the savings banks. The net receipts arising from all non-bank transactions with abroad were unavoidably associated with the rise in holdings of external currency (including sovereigns, other foreign coins and British currency notes) and with the accumulation by the banking system of external assets in London.

While the growth in bank deposits was directly associated with the accumulation of external assets abroad by the banks, it was also the case that the growth in bank deposits reflected the increase in the banks' domestic lending. In other words, the accumulation of bank deposits reflected both the rise in the external assets of the banks as well as that in their domestic lending. However, the rise in the currency circulation was mainly associated with net receipts from abroad that did not become part of the external assets of the banks.

The decreases that occurred from time to time in the level of the currency circulation and in bank deposits were associated with temporary deteriorations in the value of exports (arising from contractions in external markets, bad domestic harvests and adverse movements in the international prices of agricultural products). Such developments also tended to be associated with reductions in the banks' external assets as well as in their domestic lending, the contractions in lending being more pronounced when harvests were bad. Outflows of deposits for investment abroad also led to a contraction in the banks' external assets. However, reductions in currency holdings, especially after 1845, would not have led to a corresponding decline in the banks' external

liquid assets as most of the currency in circulation was an external asset or the equivalent thereof. Excessive domestic bank lending, contributing to increased imports, capital outflows and a reduction in the banks' external assets, has been much more a feature of the second half of the twentieth century than of earlier times, especially when one excludes the period of the Napoleonic Wars.

As the Irish economy was part of the sterling area, one would expect that banks in Ireland were constrained from paying much less for deposits or charging significantly more for credit than the banks in internationally competitive Britain. Nevertheless, familiarity with and knowledge of the local Irish scene enabled Irish banks to charge most of their customers somewhat more for credit and pay them somewhat less on deposits. However, even with banks channelling part of the domestic savings into external assets in the form of balances in London, one would expect also that it did not result in large profitable investment opportunities in Ireland being neglected; the banks had an incentive in the form of expected higher profits to lend in Ireland if the returns were as high or higher than abroad. Furthermore, since major borrowers in Ireland could have direct resort to the financial institutions in London and since profitable investment opportunities in Ireland were always free to attract the externally-oriented British investors, one would expect that potentially profitable investment opportunities in Ireland would not be neglected. Irish firms also had the opportunity to raise funds on the Dublin, Cork and Belfast Stock Exchanges which they had resort to, especially in the period 1870 to 1900, when many Irish businesses became incorporated under the company legislation and raised capital by share issues to the public. The main reason for the accumulation of external assets by the banks was the emergence, in a free trade environment, of external trade surpluses by the agricultural sector at a time of limited profitable investment opportunities in the rest of the economy and the absence of locally-oriented fiscal and regional policies.

Taking a broader picture, it would be difficult also to conclude that economic development in Ireland was held back by the banking system especially when the experiences of banking with industrial development in the north eastern part of the economy are taken into consideration. However, what seems surprising, in the context of no exchange rate worries and full membership of the sterling area, was the extent to which the banks held external assets in liquid form rather than diversifying to a greater extent into lending in Britain with a view to enhancing their profits. It seems reasonable to suggest that the accumulation of external liquid assets by the banks did not give rise to a lower level of investment in Ireland when one also considers the extent to which bank credit for seasonal and stock carrying purposes was provided and that a hard core of overdraft accommodation remained continuously outstanding in support of capital



investments. Moreover, until well into the twentieth century, little of the savings entrusted to the banks was extended to finance consumption.

It should not be concluded that membership of the Sterling area did not have a significant impact on the development of the Irish economy. While it is difficult to establish that monetary integration itself impeded economic development, an evaluation of the overall economic effects of integration within the sterling area would have to take into consideration the effects of the budgetary, trade and other economic policies pursued. A historical review that focused specifically on the economic as well as the monetary features of the union that existed between the Irish and British economies might contribute to forming a deeper appreciation of the economic and monetary implications for Ireland of full integration within the European Community.

### **Joint Stock Banking: Early Decades**

Branch banking did not emerge until the mid 1820s, which may have been partly associated with the rise in commercial activity being centred initially on the larger towns rather than being more widespread throughout the country. Following the increase in familiarity with currency notes during the Napoleonic Wars, the reduction in the number of private banks outside Dublin to about ten, and the improvement in the economic situation following the severely depressed conditions of the early 1820s, a more widespread and growing demand for the services of banks began to occur. This growing demand was supported by a number of legislative changes in the 1820s. Only one major bank existed in the early 1820s, the Bank of Ireland, which was located in Dublin and had not yet embarked on establishing branches throughout the country. Thus, an opportunity existed for joint stock banking to emerge as was occurring abroad especially in Scotland but also in England.

The distinctive feature of joint stock banks was their large number of reasonably widely dispersed wealthy shareholders with unlimited liability. Bank customers, therefore, developed a high degree of confidence in joint stock banks. This was in marked contrast to their attitude towards single branch private banks in earlier times which relied excessively for their supporting capital on the fortunes of a small number of individuals or families (by law no more than six). The circumstances were now propitious for the spread of branch banking to which joint stock banking readily lent itself on account of the confidence it generated with prospective depositors and holders of bank notes throughout the country.

The need to open up entry into banking and to provide competitive banking services throughout the country was recognised by the authorities following strong representations from business interests in Belfast. Indeed, the authorities probably recognised that, apart from the Bank of Ireland which was concentrating on Dublin, there would be little opposition from established

bankers to legislative measures that would open up the way for joint stock banking throughout the country. Legislative changes in the first half of the 1820s made provision for joint stock banks that wished to issue currency notes outside of a radius of sixty five miles from Dublin in direct competition with the Bank of Ireland. Such banks would also be free to establish themselves within the Dublin region provided they refrained from issuing currency notes, thereby leaving the Bank of Ireland with the sole right of note issue in the Dublin area. However, within the Dublin region, the Bank of Ireland would remain exposed to competition from joint stock banks that would choose to establish themselves in the Dublin region without the right to issue notes.

The most significant development in Irish banking in the last century, and indeed up to the 1960s, was the establishment of seven successful joint stock banks over the twelve-year period 1824 to 1836. Apart from the Bank of Ireland (which was already established by charter some forty five years earlier) and the Munster and Leinster Bank Limited (which emerged some fifty five years later in the southern region of the country), all of the other clearing banks operating in Ireland up to the 1960s were established in the hectic twelve years up to 1836. The emerging banks in this period consisted of three different strands – three Presbyterian-supported banks centred on Belfast; two in the Dublin region with some external capital backing to compete with the Bank of Ireland (except in regard to the issue of notes); and two, with significant backing of external capital and with head offices in London, which concentrated on the rest of Leinster, Munster and Connacht but not to the exclusion of Ulster.

The first joint stock bank – the Northern Banking Company – was founded in 1824 in Belfast. The northern region of the country did not have a strong private banking tradition. By the early decades of the nineteenth century this part of the country was becoming a major centre of economic growth and, rather than continuing to rely on coinage, especially gold, was developing a strong demand for banking facilities. It was in response to this need that the Northern Banking Company was established by a group of local shareholders with an industrial background. In the Dublin region, the Hibernian Bank, with Catholic support, was established in 1825, challenging the monopoly of the Bank of Ireland in this area. Likewise, the Provincial Bank of Ireland was also established in 1825, with strong Scottish backing and its head office in London. The Provincial Bank played a major role in promoting competition in Irish banking before a much less competitive banking environment was gradually created over the period 1886 to 1921 through common agreements on a number of issues established among the banks themselves.

In 1827, the Belfast Banking Company was established and, in the process, absorbed the two remaining private banks that operated in the north of the country. After a lag of nine years, the National Bank was founded in 1836 by

Daniel O'Connell with sizeable external backing. An objective of this bank was to introduce banking more deeply into the rural communities than was being done by the Scottish-supported Provincial Bank and the Dublin-oriented and Anglican-supported Bank of Ireland. Only a few years earlier, in 1829, O'Connell, for political purposes, was advocating bank customers to convert currency notes into gold, that is, he promoted runs on banks. The National Bank also established a significant presence in England, both among the larger Irish communities as well as in the City where its head office was located, and it was admitted to the prestigious London Clearing Banks Committee in the 1850s. The Royal Bank of Ireland, with the support of the Quaker community, was also established in 1836 and created a more competitive banking climate within the Dublin region. Later that year, the youngest of the joint stock banks – the Ulster Bank – was established with head office in Belfast. One of its objectives was to compete primarily in the northern part of the country with the two north-eastern oriented banks that had already been in existence for about a decade and with the Bank of Ireland and the Provincial Bank of Ireland which were also establishing themselves in Ulster.

The Ulster Bank moved outside the province of Ulster in 1860 when it opened a branch in Sligo and in 1862 when it opened a branch in Dublin – the first of the northern-based banks to do so in the capital city. A quarter of a century was to pass before the Northern Banking Company opened a branch in Dublin in 1888 to be followed by the Belfast Banking Company in 1891. However, the Belfast Banking Company was the first northern-based bank to move outside the province of Ulster in 1850.

By 1836, there were just over 130 branches located in the towns throughout Ireland compared with no more than a few branches a decade earlier. The introduction of bank branches to the towns helped to diversify risk for the owners of banks but banking services were not extended to any significant extent to the middle and lower income groups both in rural and urban areas until recent times. Indeed, for many decades after their establishment, individual banks were closely identified with the religious persuasion – whether Anglican, Presbyterian, Catholic or Quaker – and the wealth and income earning capacity – whether landed, merchant or professional – of their founders, shareholders and large customers. However, with the passage of time, a growing proportion of the economically active population became involved with banking and this was reflected in the decline of the Protestant proportion of bank officials in the Republic to around 50 per cent in the mid 1930s – a development drawn to our attention by R.F. Foster in *Modern Ireland 1600–1972*.

In 1836, bank notes in circulation amounted to around £5 million while deposits with banks were somewhat less, perhaps £4 million. A further boost to competition in the eastern region was given in 1845 when all of the note issuing

joint stock banks in existence at that time were given the right to issue their own notes throughout the whole of the country. Notes outstanding beyond the aggregate level of £6.4 million, had to be backed by gold or silver thereby favouring the growth of bank deposits and the circulation of British currency, that is, sovereigns and Bank of England notes rather than Irish bank notes. By 1845, deposits in the Irish banks had increased to some £8.0 million.

These developments in joint stock banking were accompanied by a rapid but short-lived growth in the number of savings banks throughout the country. There were seventy nine savings banks in existence in 1836 with aggregate deposits of £1.8 million. Following this rapid rate of increase, many savings banks experienced difficulties especially during the 1840s despite the dedication and voluntary support of those associated with the savings bank movement. Confidence in the savings bank movement was shaken in the mid 1840s when the liability of trustees and managers to make good deficiencies in the funds of a savings bank was removed by the 1844 Savings Bank Act. Another factor that contributed to reducing confidence was the closure of some twenty five savings banks during the second half of the 1840s. In 1848, three savings banks – the Tralee, Killarney and Cuffe Street bank in Dublin – collapsed at the expense of depositors because of serious frauds.

A Select Committee of Parliament was appointed to inquire into these frauds which resulted in legislation being passed in 1849 which increased the responsibilities of trustees to the depositors and provided for the appointment of auditors. It is probable that this legislation did much to prevent a major collapse of the savings bank movement in Ireland. By 1845, aggregate deposits in the savings banks amounted to nearly £3.0 million. Even in 1914 they did not exceed this level by which time the number of savings banks in Ireland had gradually fallen to eight through both closures and mergers. The savings banks were not direct competitors of the joint stock banks as the former concentrated their activities among the non-Catholic lower income groups especially in larger towns thereby confining themselves to a relatively small market, particularly outside Ulster.

The experiences of private banking, of the early savings bank movement and of a number of the small joint stock banks that did not survive, highlight the importance of holding an adequate amount of cash and short-term assets and continuity in the availability of adequate capital to support a bank's deposit liabilities. Historical experience also highlights the need for the application of high standards in respect of probity, competence and capacity. Reliance on the personal wealth of a small number of persons is not normally conducive to sustaining adequate capital especially in a bank or other deposit-taking financial institution that wishes to grow in a stable manner.

## **Banking Structure: 1840s Onwards**

The Munster and Leinster Bank came into existence in 1885 with its head office in Cork. Apart from it, few other joint stock banks of significance were launched or survived after 1836. South Tipperary was the only inland region with a firmly-based banking tradition going back to the private banking days of the mid eighteenth century. In the 1830s three banks, which were short-lived, were established in County Tipperary in the prosperous Suir Valley with its Quaker settlements (the Clonmel National in 1836 which merged with the National Bank in 1856; the Carrick-on-Suir National in 1836 which also merged with the National Bank in 1856; and the Tipperary Joint Stock or Sadlier's Bank in 1838 which failed in 1856 because of fraud, bringing in its wake much suffering for many families of modest means and temporary runs on local bank branches).

Although the private joint stock banks became incorporated entities between 1865 and 1869, their shareholders could not avail of the protection of limited liability until legislation was passed in 1879, and by 1883, the banks had extended limited liability to their shareholders. Prior to the 1880s it was relatively easy to attract capital into banking even with unlimited liability. However, it became less easy to do so as a result of the large losses experienced by bank shareholders when the City of Glasgow Bank closed its doors in 1878. Thus the adoption of the provisions of the 1879 Act encouraged bank shareholders to provide additional capital for banks from the early 1880s onwards. Banks also began to publish their annual accounts on a regular basis in the 1880s. This helped to keep both shareholders and depositors informed from year to year about the affairs of the banks and thereby facilitated the raising of additional capital for them.

A noteworthy development, during reasonably prosperous times, was the establishment in Cork of the Munster Bank in 1864. The Munster Bank embarked on a rapid expansion of branches mainly in the southern region of the country and, in 1870, it established a presence in Dublin when it merged with La Touche, one of the few remaining private banks. It tended to concentrate on the agricultural community and operated with a relatively high ratio of lendings to deposits. This left the bank exposed, especially when it became known that interest on relatively large unsecured advances to major shareholders was not being paid, and it had to rely on the Bank of Ireland for temporary assistance. With a further deterioration in the financial condition of the Munster Bank, the Bank of Ireland decided to put a limit on the growing amount of credit it was prepared to grant in the cheque clearing to the Munster Bank and indicated that it would not continue to honour its cheques if that were to result in the limit being exceeded.

Against this background the Munster Bank closed its doors in 1885. This led to questions in Parliament and to an exchange of correspondence between the

Bank of Ireland and the Chancellor of the Exchequer in which the Bank of Ireland was reminded of its privileges and its associated responsibilities. Later that year, arrangements were made to raise capital locally which culminated in the incorporation with limited liability of a new major bank with head office in Cork. This occurred in 1885 when the Munster and Leinster Bank was established with Catholic support and, in the process, took over the assets, without any loss to its existing depositors, of the Munster Bank, some twenty years after it was initially launched. However, the shareholders of the Munster Bank had to forfeit their capital in order to meet the deficiencies that had arisen in the assets of the failed Munster Bank.

The newly established bank was enthusiastically supported by the local community. It pursued a conservative lending policy which gave it a relatively high ratio of liquid or readily encashable assets to deposits. It also competed vigorously for new accounts especially those of local authorities; and, after concentrating on the provinces of Munster and Leinster for some forty years, set out to be a country-wide bank. It established a branch in Belfast in 1918, the first outside the provinces of Munster and Leinster. This bank did not have the right to issue its own currency notes as banks established after 1845 were prohibited from doing so.

The Post Office Savings Bank, with its ready made nationwide outlets even in remote areas, was established by the government in 1861. By 1885 its deposits exceeded those of the trustee savings banks. This initiative was taken partly because of concern that had existed since the 1840s about the stability of the savings banks and which was reflected in their reducing level of deposits since 1844. All of the deposits placed in the Post Office Savings Bank and the trustee savings banks were invested abroad in British government paper until the 1930s when the first steps were taken to convert the savings banks' foreign assets into Irish government securities, including balances at the Central Bank.

This process, which was interrupted in the 1940s when there were substantial increases in the foreign assets of the savings banks, continued through the 1950s and early 1960s. Most of the remaining external assets of the Post Office Saving Bank were converted into the official external assets in 1964 – a process that was not completed until 1969 when the remaining foreign assets of the banking system were being transferred to the Central Bank. The Post Office Savings Bank recorded steady progress up to the 1960s, especially in the 1940s, in competition with the clearing banks, particularly in rural areas with their limited transport facilities and without ready access to clearing banks.

There are ten<sup>4</sup> building societies in Ireland of which four were established in the period 1861 to 1883, two in the 1930s, one in the mid 1950s and three during the 1970s. The building societies, however, were not destined to play a significant

part in the Irish financial sector until the 1960s. This reflected the dominance of the rural sector in the Irish economy until recent decades and the limited scope until recent times for financing the personal acquisition of marketable privately owned single dwellings. Guinness & Mahon, the only private banking partnership to maintain its individual identity, was established in 1836 and it was not until 1966 that it was converted into a limited company. The founding families of Guinness & Mahon also penetrated the London financial scene in the 1880s and established a successful merchant banking business in the City which, in more recent times, became the parent or owner of its Dublin-based sister bank. In 1989 the Bank of Yokohama became the ultimate dominant shareholder of Guinness & Mahon.

The basic structure of Irish banking was to remain unchanged from 1885 up to the 1960s. The only significant structural change to occur in the meantime was the take-overs in 1917 of the Belfast Banking Company by the Midland Bank and of the Ulster Bank Limited by the National Westminster Bank. Sizeable amalgamations between major banks had been occurring around the same time in British banking which was officially discouraged in 1918.

In 1919, the Dail established the National Land Bank which was taken over by the Bank of Ireland in 1926 and renamed the National City Bank Limited in 1927. Some forty years later, that is, in 1968, Chase Manhattan Bank purchased a major stake in this bank and its name was changed to Chase and Bank of Ireland (International) Limited, before being fully absorbed into the Chase Bank (Ireland) Limited in 1979 - a bank that has scaled down its operations significantly since the mid 1980s. In 1923, shortly after the Irish Free State was established, the Royal Bank of Ireland exchanged its branches in Northern Ireland for those of the Belfast Banking Company in the Republic thereby reducing competition in banking in both areas. Furthermore, in the 1920s, the registers of British Government Stock held by Northern Ireland residents were transferred from the head office of the Bank of Ireland to its main branch in Belfast. No further significant structural change in banking was to occur until the late 1950s apart from the transferring of the head office of the Provincial Bank from London to Dublin in 1953. The head office of the National Bank Limited was never transferred from London to Dublin as it would have resulted in the loss of London clearing bank status.

A striking feature of the evolution of the Irish banking industry over the centuries is the extent to which it corresponded with what was occurring in Scottish and English banking. This may be attributed to two different but supportive influences. One was the extent to which knowledge, technique and experience were being transferred across national boundaries independently of the authorities. This was facilitated by the existence of a fixed rate of exchange and no barriers to capital movements between Ireland, Scotland and England.

The second and probably more important influence was the legislative and policy initiatives that were taken. Before the Act of the Union, the influence of legislation and policy on Irish banking created differences with what was happening in Scotland and England. There was reasonably strong resistance in Ireland to the spread of British influence over Irish banking. This delayed for many decades the emergence in Ireland of what is nowadays known as central banking functions which were eventually introduced, mainly as a result of imbalances in the fiscal finances in Ireland in the international aftermath of the American Declaration of Independence in 1776. Other legislative initiatives concerning banking in Ireland in the eighteenth century also seemed to be primarily concerned with Irish problems, e.g., discouraging merchants engaged in foreign trade from becoming involved in banking business.

In the nineteenth century following the Act of Union, there was a significant shift in the direction of policy and legislation. From then onwards Irish banking followed very closely what was happening in the United Kingdom especially in the first half of the nineteenth century. The monetary and banking reforms together with supporting legislative changes introduced in the UK after the Napoleonic Wars were extended without resistance to Ireland. Similarly, in the 1840s monetary control was extended over banking in Britain and in Ireland when the central position of the Bank of England was strengthened in England at the same time as that of the Bank of Ireland was weakened in Ireland. By the 1840s, it was clear that the British authorities did not envisage the emergence of a central bank in Ireland with a monopoly of the note issue. After 1845, apart from legislation concerning the conduct of banking business from a commercial viewpoint, there were no substantive changes for seventy years in monetary and banking legislation either in Britain or in Ireland. Significant specific legislative changes in Irish banking were not to occur before the late 1920s.

There was a high degree of confidence in Irish banking over the past two centuries and the basic banking services provided in Ireland were of a similar quality to those available abroad, especially in Scotland and England. By international standards, Irish banking was a safe haven for savings especially since the holders of the currency notes issued by banks and their depositors, as distinct from shareholders, did not experience significant losses in the event of bank failures. However, in instances where depositors did experience some losses through the failure of very small banks, the authorities – in pursuing the policy-objective of the times of placing full responsibility for the management of risk with the private investors – did not become involved in providing funds to rescue the ailing banks or for the purposes of partially compensating their depositors. The only exception in Ireland was an Exchequer contribution in 1977, which has amounted to less than £1 million, to the depositors of a very small local bank – Irish Trust Bank – that went into liquidation in 1976. Furthermore, no losses have been experienced over the years by those who placed their savings



with building societies. Efficient arrangements for making payments have prevailed in Ireland especially since the disappearance of the shortage of coinage after the Napoleonic Wars. Innovations in banking were also introduced into Irish banking without much delay, particularly from the 1820s onwards in a commercial environment that did not rely on the state for support.

### **Financial Innovation: 1820s to 1950s**

The four most important financial innovations in Irish banking in the last century were the institution of arrangements for exchanging currency notes between banks; the introduction of clearing facilities for cheques; the emergence of the secured overdraft facility at a time when a growing proportion of firms were adopting limited liability status; and the bringing of banking to the customer by establishing bank branches in local towns throughout the country. These innovations reflected the demands for savings and payments facilities and for seasonal and long-term credit.

Currency notes in circulation increased significantly between 1800 and 1845 – from almost £3 million to £6.4 million – when a limit was placed on the issue of currency notes by banks unless backed by gold or silver, provided the silver did not exceed one quarter of the amount of gold. One major innovation that emerged from the growth in the circulation of bank notes was the establishment, on private initiative, of an arrangement between the banks for the clearing or exchanging of one another's notes. The rise in the circulation of currency notes issued by the Bank of Ireland and the emergence of joint stock banks with their own note issues and growing branch networks led to co-operation and the establishment of a bank note exchange between the banks in 1825 under the auspices of the Bank of Ireland.

As the banking system developed and grew in confidence it introduced another major innovation, namely the cheque, for the purposes of making payments. This instrument was more convenient and safer than notes and coin for discharging large payments. It was also more profitable for banks to provide cheques rather than issue currency notes. This was because the banks' current account liabilities against which the cheques were drawn could be partly supported by relatively high yielding assets rather than with non-interest yielding gold and silver coins, with which issues of currency notes had to be matched after 1845. As early as 1845, another private innovation requiring co-operation between competitors, again organised under the leadership of the Bank of Ireland, took place when facilities for the exchanging or clearing of cheques between the banks were established. However, the very small increase in the currency notes issued by the Irish banks, from £6.4 million in 1845 to £6.7 million in 1900, was probably more associated with the scope provided for an increase in the amount of British currency, including sovereigns, in circulation rather than with the growing popularity of cheques for effecting payments. One

cannot rule out that emigration and a gradual decline in prices in the last quarter of the nineteenth century may have had some bearing on the more or less static figure for Irish bank notes outstanding after 1845.

Those banks with the right to issue notes were able to carry their normal level of till money free of interest costs. They accomplished this by maintaining their own note issue in line with the amount of till money, that they considered it necessary to hold in the form of gold and silver coins, to support their scale of business. If they increased the circulation of their own notes to a level that required them to hold gold and silver coins in excess of normal till money requirements, they would not be adding to their profits. This experience discouraged banks from issuing their own notes beyond a certain point, that is, the level of till money required for operational purposes, with the result that bank deposits and British currency acquired a more prominent position. These arrangements led to bank deposits, including those with the Post Office Savings Bank, sovereigns and British currency notes rising as a proportion of savers' portfolios at the expense of Irish bank notes.

Deposits with banks, which consisted mainly of savings rather than balances for effecting payments and which were probably the dominant liquid or encashable component of wealth, increased from about a level of £8 million in 1850 to some £43.0 million in 1900. Savings were also being accumulated with the savings banks, particularly the Post Office Savings Bank, which in 1900 aggregated to some £10.5 million compared with £3 million in 1845. No data are available on the magnitude of the rise in the circulation of coins, including sovereigns, and Bank of England notes, between the 1840s and the early 1900s – a period during which the economy was increasing at some 0.7 per cent a year despite a substantial contraction in the population.

The indications are that, by reference to the amount of the gold coinage withdrawn during the early years of the World War I, the value of the circulation of gold coinage at the beginning of World War I, may not have been far short of that of the Irish bank notes in circulation. The subsequent experiences of the late 1920s, with the substitution of new Irish currencies for the note issue of the Irish banks and also for British currency in circulation, suggest that the amount of Bank of England notes then in circulation may have been about one and a half times that of the active Irish bank note circulation. One could conclude that the circulation of Bank of England notes in Ireland prior to 1914 may not have been much in excess of the aggregate circulation of gold coins and Irish bank notes.

Another major innovation in banking was the development of the overdraft method of lending. While the overdraft had been a feature of banking since the 1820s it did not become popular until the last quarter of the nineteenth century, when the advantages of the secured overdraft became more widely

appreciated, at a time when a growing number of firms were adopting limited liability. The specialised financing needs of industry that emerged in other countries did not become a strong feature of Irish banking outside Ulster because of the continuance of the strong agricultural base to the economy, the absence of a dynamic corporate sector, and the direct links of the small number of large transport, manufacturing and trading firms with the London capital and financial markets.

Apart from the emergence of stock broking partnerships towards the end of the eighteenth century and the gradual evolution of the stock exchanges since then, there were no significant innovative developments in the financial markets in Ireland until recent times. This was because of the relatively low level of government borrowing until recent decades; the centring by the banks of their external assets on London primarily in liquid form; and because the total amount of capital raised by issues of equity on the stock exchanges in Ireland was not substantial. A feature of the sterling area was that it discouraged the development of national financial markets. It centred both the accumulation of liquid assets by financial institutions and the large-scale borrowings of governments and major corporations on the internationally-oriented institutions and markets located in London.

At the local level, the banks penetrated the growing retail market for banking facilities by continuing to extend their branch network throughout the country from the 1820s up to the early 1920s. This development also reflected inter-bank competition to meet the growing demands in local towns for bank services, especially depository and cashing facilities. Close on 130 branches were opened in the decade 1826 to 1836. Fewer branches were established between 1836 and 1860 when the number increased by only 50 to around 180 reflecting the effects of the Famine and static economic conditions in Ireland. Over the next two relatively prosperous decades, up to 1880, some 300 branches were established. This was followed by a rise to 660 in 1900 mainly by way of sub-office expansion in sluggish economic circumstances.

Competition in establishing branches became intense after 1900. During the disturbed but exceptionally prosperous (especially for agriculture) two decades up to 1920, when savings were growing rapidly, the number of branches almost doubled to around a figure of 1260 in 1920. The doubling of the number of branches in the first two decades of this century was associated with a more than four-fold increase in the amount of savings held with the banks. Currency notes issued by the Irish banks rose from £6.7 million in 1900 to £26.6 million in 1920. Much of this increase occurred during the period 1914 to 1920 when gold sovereigns were being withdrawn, the currency notes were enjoying legal tender status and prices were increasing rapidly – by 150 per cent over the six-year period.

Deposits with the clearing banks increased more evenly during these decades from £43 million in 1900 to £183 million in 1920. The savings banks, because of strong competition from the clearing banks as reflected in the large number of new branches established by the latter, experienced a more modest rate of expansion in the twenty years to 1920 when their deposits increased by £7.0 million to a level of £17.5 million. The extension of branch banking over the nineteenth and early twentieth centuries enabled the banks to diversify their sources of funds and lending portfolios and avoided the establishment of a large number of small local banks with relatively risky lending portfolios. This contributed to the high degree of stability of banking in Ireland over the past 150 years or so and reduced the number of bank failures and abortive mergers that otherwise would have occurred.

The boom in banking activity that had been occurring over the first two decades of the twentieth century came to a sudden halt in the early 1920s. A contraction in the level of deposits with banks was experienced during the 1920s and 1930s. In addition, a consensus emerged that a number of towns had too many branches. This led to a small reduction in the branch network, particularly during the 1940s. However, deposits with banks began to increase again from the early 1940s onwards as a result of the impact of World War II. This resulted in a lowering in the level of imports and a raising of the prices for agricultural exports, a phenomenon reflected in a substantial balance of payments surplus during the first half of the 1940s. Bank deposits, including those with the Northern Ireland banks, increased by some £300 million over the twenty-year period 1940 to 1960. It is estimated that deposits throughout Ireland with the savings banks, which had recorded little change between the early 1920s and late 1930s, also rose during the 1940s and 1950s, by around £140 million to a level of £160 million in 1960. This represented a much higher rate of growth in funds placed with the savings banks – the opposite to what was experienced in the previous expansion between 1900 and 1920. The more prominent position of the savings banks in the mid decades of the twentieth century may be attributed to the fact that the branch network of the clearing banks was being reduced, thereby enabling the savings banks to capture a larger market share.

Since 1960, there have been major structural changes in the financial sector both in the Republic and in Northern Ireland with the building societies and subsidiaries of the clearing banks coming to the fore at the expense of the public sector institutions especially the Post Office Savings Bank. Since statistics about a number of the financial activities or institutions in Northern Ireland are not shown separately from aggregate UK data, it is not possible to quantify with confidence the relative sizes in the 1980s of the different categories of financial institutions in Northern Ireland. Apart from the question of the difficulties in handling the data for Northern Ireland, comparisons between its financial institutions and those in the Republic are more difficult to make nowadays

because of the fluctuations in the exchange rate between the Irish pound and sterling. As regard the branch network, a further small reduction in the number of offices has occurred since the 1960s especially in the Republic. While the amalgamations of the banks and the advent of the travelling bank gave scope for the closing of bank branches in rural areas, this was partly offset by the need to establish branches in the rapidly expanding urban areas.

### **Central Banking: After Independence**

The most significant changes in Irish banking in this century are firstly, the reinstatement of the Irish currency and the establishment of the Currency Commission/Central Bank of Ireland following political independence in the early 1920s; secondly, the structural changes in banking from the 1960s onwards; and, thirdly, the implications of the breaking of the fixed link between the Irish pound and sterling in 1979.

When the state was founded in the early 1920s, the per capita level of income in Ireland compared favourably with that in many European countries. Ireland also had a relatively advanced banking system that was fully integrated into the sterling area and held ample liquidity in the form of sterling balances. One of the main characteristics of membership of the sterling area was the free movement of capital at internationally competitive rates of interest not only between Ireland and the United Kingdom, but also with the rest of the sterling area. Moreover, as far as the sterling area countries were concerned, there was free movement of capital from them to the rest of the world.

Another significant feature was the fact that the London financial institutions and markets acted as the lender of last resort to the banks in the member countries of the sterling area. In the eighteenth century, private Irish banks had correspondent associations with banks in London and in the first half of the last century, the Bank of Ireland could rely on temporary support from the Bank of England not only on its own behalf but indirectly on behalf of other Irish banks that found it necessary to have resort to the Bank of Ireland rather than going directly themselves to London.

As the nineteenth century progressed, Irish banks relied less on the Bank of Ireland for temporary accommodation as they themselves accumulated sterling liquid assets and British government securities and centred the management of their growing liquidity on London. The Irish banks' liquid balances in London increased when external trade grew more rapidly than the rest of the economy; when lending opportunities in Ireland were not attractive as in the 1880s and 1890s; when outflows associated with the servicing of past British investment in Irish railways and the transfer of rents abroad tapered off from the 1880s onwards; and when agricultural exports prospered especially during World Wars I and II. As recently as 1950, half of the savings placed with banks were held

abroad in the form of short-term balances with financial institutions and marketable British government securities.

Another hallmark of the sterling area was the existence of fixed rates of exchange between member currencies which led to sterling being accepted without question for making payments and acting as a store of value throughout the sterling area. In the 1920s, British notes and coins circulated freely in Ireland as had been occurring over the previous one hundred years. The British currency notes, which were never legal tender in Ireland, circulated freely alongside the currency notes issued by the Irish banks and were automatically exchangeable at par with the Irish bank notes, which also did not have legal tender status except during the period 1914 to 1919. British sovereigns, which were the only form of legal tender in Ireland since the 1820s, had virtually disappeared from active circulation since the early years of the World War I with those that remained in private possession being regarded as valuables or part of wealth rather than active means for making payments.

The banks throughout Ireland experienced a very rapid rate of growth in the three-year period 1918 to 1921 when their lending rose by £50 million or 100 per cent and their deposits by £80 million or some 60 per cent. This expansion was probably associated with restocking and replacement after World War I. Over the next four years to the end of 1925, the banks' lending remained more or less stable while their deposits fell by some £30 million or nearly 15 per cent as prices unwound and as the economy slowed down in the aftermath of World War I. The banks' deposit accounts and to a lesser extent their lending continued to contract, but more modestly, during the second half of the 1920s. They remained static up to the mid-1930s before recovering in the late 1930s and increasing thereafter, at times excessively. No data are available to facilitate a comparison between the experiences in the Republic and Northern Ireland during the 1920s but it is probably that there was a contraction in the role played by the banks in both areas as had also been occurring in Britain during the 1920s. The indications are that although the money supply contracted in the 1920s and remained static in the 1930s, bank credit did not contract during these decades. It remained static in the 1920s and recorded a modest increase in the 1930s.

The use of bank cheques and accompanying arrangements for exchanging or clearing them and settling the net differences between banks had also been a well-established feature of Irish banking from as far back as the 1840s. Thus, in the 1920s, Ireland had a highly efficient cheque payments system by international standards, both in terms of the costs of cheque transactions and the length of time before they were presented for payment. It extended not only throughout Ireland but also was fully integrated into the domestic regional and international cheque clearing and settlement arrangements of the English clearing banks. During the 1920s deposits with the clearing banks, that is, the

banks that provided cheque payment facilities to their customers, and the savings banks in Ireland were also regarded as being denominated or expressed in sterling.

When Ireland became independent again, it is not surprising that the authorities were slow to disturb the efficient payments arrangements that existed not only within the country but also in respect of over 90 per cent of the country's international trade and virtually all of its external capital transactions. There was also widespread confidence by both residents and the recently-designated non-residents in Northern Ireland and Britain in both the currency in circulation and in bank deposits whose real purchasing power was increasing in the 1920s because of declining prices. The authorities were most anxious to preserve this widespread confidence especially in view of the international concern in the first half of the 1920s about the effects of the hyper-inflation being experienced in continental Europe. The existing arrangements offered the prospect of continuity in the efficient payments facilities and in the stability of the value of the currency. This was to be welcomed in the less buoyant economic circumstances of the 1920s compared with the relatively prosperous conditions, especially in rural Ireland, in the opening decades of the century which reached a peak during World War I when prices rose substantially.

After careful consideration of the reports of a commission appointed in Spring 1926, the government decided in 1927 that it would be in the national interest to effect two significant reforms – one to reinstate legally the Irish pound, the other to introduce into circulation a distinctive set of Irish notes and coins. These reforms were only to be introduced on the clear understanding that there would be no exchange controls between Ireland and Britain and that the Saorstat pound would exchange on a one-for-one no margins basis with the pound sterling. This meant that there would be no change whatsoever as a result of the reforms in the value or purchasing power, in terms of sterling, of the currency and bank deposits. From the legal viewpoint, however, the reforms provided for the establishment of a different currency in the Republic from that in Northern Ireland and Great Britain. In practice, the new Irish notes and coins were quickly accepted into circulation and became in the words of Yeats 'the silent ambassadors of national taste'.

The Currency Act 1927 declared that the standard unit of value shall be the Saorstat pound, later to be described as the Irish pound in 1937. The Act also prescribed under Section 10 that every contract etc. effected after the Irish pound came into circulation, shall be made in terms of money that is legal tender in the country unless the contract etc. is expressed in the currency of another country other than the Irish state. The provisions of the Act became effective in 1928 with the introduction of the Irish legal tender notes and the Irish coinage in substitution for the British currency which freely circulated but without legal

underpinning. However, it was not until the 1970s, when fixed exchange rates became the exception in the world and the fixed link with sterling was being questioned, that the banks began to clarify for their customers that their deposits were expressed in Irish pounds unless otherwise specified.

The other major reform was to establish institutional arrangements to manage the Irish currency and to ensure that it would continue to be backed 100 per cent by sterling. It was also envisaged that the new arrangements would avoid the extension of interest free credit to Britain which followed automatically from the circulation of British currency in Ireland. The retention in Ireland of British currency for the purposes of effecting domestic payments was equivalent to the holding of British government paper on which no interest or dividend was directly received. It made economic sense to incur the expense of providing Irish currency as this cost would be only a fraction of the interest or receipts of dividends being forgone.

The new institutional arrangements to give effect to these reforms led to the establishment of the Currency Commission in 1927 whose capital was subscribed by the clearing banks though its board was heavily influenced by representatives of the public. This institution – the forerunner of the Central Bank of Ireland – was made responsible for introducing the newly-designed Irish notes and coins in exchange for British currency which was repatriated. This enabled the Currency Commission to provide a 100 per cent sterling backing for the Irish currency by acquiring sterling assets on which interest was earned. Initially, the circulation of Irish currency rose rapidly to the level of £6.5 million in 1929 and then recorded a modest increase of around £0.5 million over the next five years. This experience with introducing the new Irish notes into circulation suggests that the amount of British currency notes in circulation in Ireland was not significantly in excess of the amount of currency notes that had been issued by the Irish banks. As increases in Irish currency in circulation began to exceed the amount of sterling repatriated, the Currency Commission continued to accumulate sterling assets to back the issues of Irish currency. Such excess issues of Irish currency were only made available to the banks in exchange for sterling balances in London. The reforms of the late 1920s set the legal background for the gradual distancing of the management of Irish monetary affairs from that of Britain. This, however, did not gain momentum for a number of decades by which time economic circumstances, especially international monetary relations, had changed significantly.

With the introduction of legal tender notes, the clearing banks were no longer permitted to issue their own currency notes of which there was about £6.5 million in circulation in 1929. In addition, the banks had to commence paying interest to the Currency Commission on their currency notes that remained in circulation. This gave an incentive to the five banks concerned to withdraw their



notes and created scope for their replacement with legal tender notes. The interest payments also helped to compensate the Currency Commission for the loss of income arising from the lower circulation of its legal tender notes.

The banks were partly cushioned for some time from the effects of this development. As their currency notes were being withdrawn, each of the clearing banks was permitted to place in circulation a limited amount of quasi-private currency notes bearing its own name. These hybrid notes, which were known as Consolidated Bank Notes (or the ploughman notes in familiar terms as they featured a ploughman on their front), were provided by the Currency Commission but they were not legal tender. An upper limit of £6 million was placed on their total circulation which grew rapidly to around £4.5 million in 1931, thereby replacing within a year or so some two thirds of the old currency notes that ceased to be issued by the banks in 1929. Interest was also paid by the banks to the Currency Commission on the Consolidated Bank Notes in circulation. This reduced their attractiveness to the banks but made a contribution to the Currency Commission to offset its loss of income from not having the opportunity to issue additional legal tender notes. The circulation of consolidated bank notes never reached the maximum limit of £6 million. This transitional arrangement was terminated in 1953 – almost twenty-five years after the banks' right to issue their own private notes was withdrawn.

The next significant structural development in Irish banking after the late 1920s was the formal establishment of the Central Bank of Ireland in 1943 following a major evaluation of Irish banking by a commission which was appointed in 1934 and which reported in 1938. While central banking was firmly established in most European countries during the nineteenth century, the world wide emergence of central banks is mainly a feature of the twentieth century and was associated with the international trend towards nationalism and independence. Given these trends, especially in the British Commonwealth after World War I, it is not surprising that a central bank was established in Ireland in the early 1940s. However, it was not obvious at the time what a central bank would hope to achieve in addition to the functions already being performed by the Currency Commission.

The Central Bank took over responsibility not only for the functions of the Currency Commission but also for the duties and powers conferred on it by the Central Bank Act, 1942. Under this Act the Central Bank was given the responsibility to guard the purchasing power of the currency and to control

credit in the interest of the people as a whole. With the rapidly changing external monetary environment since the 1950s and also with the substantial increase in the role of the state, there has been a rapid rate of evolution in central banking in Ireland from the 1960s onwards.

## **Northern Ireland: Currency in Circulation**

Northern Ireland does not have an independent currency. Sterling has been in circulation there since 1826 and, unlike in the Republic, no steps were taken to replace it in the 1920s. As a result, there has been little change in the composition of the currency in circulation except that the position became somewhat more complicated between the 1920s and the 1980s with the percolation of Irish legal tender notes and coins into circulation there. Bank of England notes continue to be the main component of the note circulation. The Northern Ireland banks still have the scope to issue their own currency notes and, in addition, it is not uncommon to find Scottish bank notes in circulation. It is of interest that the per capita circulation of currency notes seems to be relatively high within Ireland.

In 1929, six of the clearing banks then operating in Northern Ireland, which had the right to issue their own private currency notes since before 1845, were allowed to continue their private bank note issue and retain some of the profits arising from the issue of these notes at the expense of the authorities. The note issue of the clearing banks must be backed, but not on a daily basis, with Bank of England notes (and coins) or non-interest balances with the Bank of England. While the circulation of the Northern Ireland bank notes continues to increase, amounting to £360 million in 1989, it has not displaced the dominant position held by Bank of England notes. In the event of a relatively rapid growth of the Northern Ireland bank note issue, the counterpart arrangements with the Bank of England would be unlikely to be sufficiently remunerative to meet the production and management costs of a substantially increased circulation of private bank notes in Northern Ireland that threatened to displace Bank of England notes from circulation.

About 20 per cent of the total note circulation in Northern Ireland consists of bank notes issued by the banks with Bank of England notes accounting for most of the remaining 80 per cent or an estimated £1,800 at end 1989. It may be only profitable for the banks to issue their own notes up to an amount approximately equal to the amount of Bank of England notes and balances with the Bank of England that they must hold to support their normal day-to-day banking business. Apart from Scotland and Hong Kong, where all of the profits of the private bank note issue are channelled to the authorities, Northern Ireland is one of the few remaining places in the world where banks are allowed to issue their own private currency notes. The substitution of Bank of England notes for the existing private note issue of the Northern Ireland banks would result in an increase in the interest-free loan to the British Authorities that arises from the circulation of Bank of England notes in Northern Ireland. But there would also be a reduction in the interest-free liabilities of the Bank of England to the Northern Ireland banks. However, the Northern Ireland banks would respond to such developments by changing the composition of their deposits, liquid assets and

loans. Such changes would eventually result in a small reduction in their profitability and perhaps in market share.

The indications are that, since the break in the link with sterling in 1979, Irish Legal Tender notes are rarely used for the purposes of effecting payments between residents of Northern Ireland. Similarly, Irish coinage virtually disappeared from circulation in Northern Ireland in the early 1980s.

## PART II : DEVELOPMENTS SINCE THE 1960s

### Clearing Banks: Structural Changes

The structure of the banking industry was much the same in the early 1960s as in the closing decades of the last century but it has changed fundamentally over the past twenty five years. Structural change in Irish banking tends to reflect what happens in the banking industry internationally, whether we look back before the 1960s, or consider what has been occurring since then. Banking and securities markets, within the constraints set by the technical limitations on communications, were reasonably international in character in the nineteenth century because of the open characteristics of the gold standard and the worldwide influence of the European colonial powers. Banking in Europe in the last century was transformed from small regional partnerships into major national and international banking institutions with headquarters in the capitals of the colonial powers.

If we look at the first sixty years or so of this century, we notice at world level a change of direction. Countries concentrated on maintaining the stability of their local banking and financial structures and there was less emphasis on multinational banking. However, over the past twenty five years or so, banking and financial markets throughout the world have again become international in orientation and have been straddling national frontiers. This external orientation was led by the major US banking institutions and security houses in the 1960s and 1970s in their drive to establish a world-wide presence and also in response to US restraints on capital outflows. At the same time, European banks were also consolidating their international representation and, in the 1980s, we had the Japanese banks establishing themselves as the foremost force internationally. This renewed emphasis on multi-national banking and internationally-integrated financial markets encouraged major structural changes in Irish banks.

The banking industry tends towards concentration into larger institutions by way of horizontal mergers, presumably to reap economies of scale by increasing market share. This occurred in the 1960s when mergers halved the number of clearing banks from eight to four. The mergers between clearing banks in the mid 1960s, which resulted in the establishment of two major Irish-owned banking groups, can be regarded as part of the process by which Irish banking strengthened itself to cope with the threat of external takeovers and increased competition from abroad, and embarked on the pursuit of economies of scale within the Irish banking market.

The Bank of Ireland consolidated its position within Ireland when it took over the Hibernian Bank Limited in 1958, and the Irish branches of the National Bank Limited in 1965; the branches of the National Bank located in England, including those in the City, were sold to a major Scottish clearing bank. The following year, 1966, Allied Irish Bank was founded through the merger of the Munster and Leinster Bank Limited, the Provincial Bank of Ireland Limited and the Royal Bank of Ireland Limited.

### **Competition from Abroad**

In the mid 1960s, the Irish banking industry was dominated by the clearing banks which accounted for some 70 per cent of the total market for short-term savings. These banks operated a cartel and entry into retail banking was inhibited other than by way of a takeover. On the other hand, there was virtually no control over the establishment of branches or subsidiaries of foreign banks that wished to concentrate on wholesale banking. In the ten years to 1975, major banks from two areas – North America and Europe – quickly established themselves and helped to create a more competitive climate in Irish banking. North American banks established their presence in the second half of the 1960s and, by the early 1970s, five major banks from this region were in operation and had acquired over 5 per cent of the banking market. Since then, these banks have scaled down their activities and have experienced a reduction in their share of domestic banking in Ireland especially in the second half of the 1980s. This mainly reflects a change of emphasis by a number of major US banks which, in the light of the international debt crisis of the 1980s and the tightening of profit margins in banking both domestically and internationally, are withdrawing from widespread representation around the globe and concentrating on the major international financial centres and the US domestic scene.

This wave of external interest from North America was followed, during the first half of the 1970s and again in the early 1980s, by the entry of a number of banks from EC member states. By this stage, entry into banking was supervised by the Central Bank under the bank licensing and supervisory powers conferred on it by the 1971 Central Bank Act. The share of domestic banking conducted by the EC banks rose from 2 per cent in 1971 to some 5 per cent in the early 1980s, at which level it has more or less remained despite the withdrawal during 1987 and 1988 of a few EC banks from their interests in Ireland.

Irish banking has also been open over the centuries to external competition from foreign banks that did not have a presence in Ireland. Nowadays, foreign banks, including Japanese banks, compete directly with banks in Ireland from the major international financial centres in providing credit facilities, not only to the public sector but also to the larger corporate borrowers. While the data on total borrowing (net) by Irish residents from external banks without a presence in Ireland are not comprehensive, they suggest that there is a reasonable degree of competition from this source. Even in the 1980s, as international banks became more cautious about extending credit across international frontiers, the magnitude of direct lending from abroad to the private sector remained close to about one-tenth of total private sector borrowing from banks within the country.

This suggests that the establishment of the single banking market throughout Europe may not have as large an effect on the availability and cost of bank credit in Ireland as some expect. Nevertheless, as a result of the creation of a single financial market in Europe, a greater range of more competitive savings facilities will probably be made available in the next decade not only by the credit institutions located in Ireland but also by those situated in other European countries. However, in the EC, the provision of retail banking services will probably continue to be dominated for quite some time ahead by local or regional banking groups rather than by major European wide banking conglomerates.

One of the advantages of having external banks in the local market is that it creates a climate that puts pressure on margins in banking. Foreign banks tend to operate with lower margins than indigenous banks in the local or regional markets. Although the share of all foreign banks located in Ireland in the domestic market for savings has not been increasing – remaining in the region of around one-tenth – they continue to be an important competitive force especially in relation to non-retail or wholesale banking. They account for over 15 per cent of total bank lending to the non-government sector. A significant part of their business is the provision of foreign currency loans to corporate borrowers at rates determined in highly competitive international markets. This brings the forces of international competition to bear on local banking which would lose its narrow-margin business to foreign banks if it did not remain internationally competitive.

The clearing bank groups – Allied Irish Bank, Bank of Ireland, National Irish Bank and Ulster Bank – successfully adapted themselves to these external forces. While retaining overdraft facilities, they introduced term lending in 1972, established specialised subsidiaries and became involved in the inter-bank market. This is reflected in the size of the total business of the clearing banks, comprising their retail, merchant and industrial activities, which has fluctuated between 83 and 85 per cent of the total domestic banking market since the early

1970s. Two major initiatives by the clearing banks – a reduction in their numbers through mergers, already referred to, and the establishment of subsidiaries on a decartelised basis in the rapidly expanding areas of the banking market – enabled them to maintain their share of the banking market throughout the 1970s and increase it in the second half of the 1980s.

The instalment credit banking subsidiaries of the clearing banks were established at the turn of the 1960s to compete with the existing subsidiaries in Ireland of UK institutions in the growing instalment credit and leasing markets. They were also established with a view to retaining as many as possible of the benefits of the cartel by the clearing banks themselves by confining the payment of relatively high rates of interest to the personal and medium-sized corporate deposits that were switched to their instalment credit subsidiaries.

Steps were taken next by the clearing banks in the mid 1960s to gain a foothold in the rapidly growing wholesale banking area when, with support primarily from UK merchant banks, they established merchant banking subsidiaries. Apart from competing with banks abroad, the establishment of subsidiaries outside the clearing banks cartel also helped to increase competition between the clearing banks themselves mainly via their subsidiaries. It is also of interest that the smaller Irish based banks were established or incorporated since the late 1950s.

These moves by the clearing banks enabled them to capture the major share of the non-clearing banking business. By 1975 the subsidiaries of the clearing banks accounted for 47 per cent of the rapidly growing business of all the non-clearing banks – a proportion that has not changed significantly since the mid 1970s.

Thus, exposure to external competition in banking helped to create a strong and competitive domestic base capable of confronting international competition with confidence. While it appears that the banking industry may have been reasonably competitive in the face of competition from abroad, it is not as easy to come to the same conclusion when we look at how it has been performing against other domestic deposit-taking and savings-collecting financial institutions. While competition from abroad tends to concentrate on major corporate clients, the challenge to the banks from domestic non-bank credit institutions for retail market share has been more penetrating. This was because of the latter's familiarity with the local scene, their relatively favourable tax treatment by the authorities, and the traditional nature of retail banking products and services before the emergence of a more competitive retail banking climate since May 1985 when each of the clearing banks was allowed to set independently its own structure of interest rates.

## **Savings Banks and Building Societies**

At the same time as foreign banks were being attracted to Ireland, an unprecedented degree of competition arose from non-bank deposit taking institutions within the country. However, the public sector institutions that compete directly with the banks for deposits, namely, the Post Office Savings Bank, the trustee savings banks (of which there are now two – with head offices in Dublin and Cork – as a result of amalgamations in the 1980s) and the State-sponsored financial institutions (Agricultural Credit Corporation and Industrial Credit Company), have been losing out relative to the banks. The aggregate share of these institutions in the market for deposits fell from 20 per cent in 1965 to 10 per cent in 1985. This aggregate view does not reveal a small relative improvement in the position of the state-sponsored financial institutions and the trustee savings banks. The latter, who have been exempt from taxation on their earnings, extended their branch networks since the 1960s and since 1965 have been providing housing finance to their depositors. But the increased market share of these institutions has been more than offset by a major contraction in the role of the Post Office Savings Bank from a 15 per cent share of the deposit market in 1965 to 3 per cent in 1985.

The story is quite different for the building societies who responded to very favourable conditions between the 1960s and the mid 1980s. At the end of 1985, their shares and deposits accounted for 18 per cent of the total savings with deposit-taking financial institutions compared with around 5 per cent in 1965 despite a substantial reduction in the number of societies to ten through rationalisation. There had been a very strong demand for mortgage finance between the mid 1960s and early 1980s, reflecting a growing population, a higher rate of marriage, rising incomes and a tax system which favoured investment in housing especially in inflationary circumstances. The societies responded enthusiastically by developing a five-fold increase in their branch and agency network throughout the country to a figure of 915 outlets (284 branches and 631 agencies) at the end of 1988. The three protracted strikes in the associated banks over the decade 1966 to 1976 supported this expansion.



These developments resulted in a major increase in the role of the building societies in recent decades whose shares and deposits at the end of 1985 amounted to nearly half of the current and deposit accounts of the Associated Banks compared with 7 per cent in 1965. Since 1986, the societies have had to face effective competition in attracting savings. This is because of the phasing out of fiscal incentives and reporting requirements to the tax authorities that favoured the societies and the vigorous entry of the clearing banks into mortgage finance, which raised their share of total mortgage finance outstanding to around 22 per cent at the end of 1988.

The clearing banks became involved in the wake of the 1973 oil crisis in providing temporary resources to building societies to enable the latter to maintain their level of housing finance. Following an initiative by the Central Bank, and in anticipation of a tax incentive in the 1976 Budget, the clearing banks introduced in the mid 1970s their own facilities for extending mortgage credit for house purchase. Since the mid 1980s, the banks are much better poised to compete with the building societies as the 1986 Budget placed banks in a more competitive position vis-à-vis the societies in the market for savings. Moreover, since September 1989 the building societies are being supervised by the Central Bank which will have an evenhanded approach to the supervision of all credit institutions. Furthermore, since 1985 one bank i.e. Bank of Ireland now holds most of the investment shares of the ICS Building Society giving the bank virtual control over the direction of the society. The Irish Life and Norwich Union building societies are in a similar position as their direction is controlled by the Irish Life and Norwich Union Assurance companies.

With these developments, the building societies are now under pressure to retain their position in the overall savings and credit markets especially in relation to the financing of housing. The societies' share of total mortgage finance outstanding at the end of 1988 was some 54 per cent compared with 57 per cent in 1985. It is also likely that the building societies will experience further competition in the 1990s for the financing of housing from external institutions as the single European financial market becomes a reality. However, under the 1989 Building Societies Act<sup>5</sup> it is also envisaged that building societies will be given the opportunity to provide payments facilities; to extend credit for non-housing purposes; and to provide, on an agency basis, a wide range of financial services so that they can compete on a much wider front with banks and other credit institutions. Responsibility for the supervision of the trustee savings banks was also transferred to the Central Bank in February 1990.

Another noteworthy institutional development has been the spread of the credit union movement throughout the whole of Ireland which, in 1988, accounted for 3 to 4 per cent of total savings with deposit-taking institutions; building society shares and deposits accounted for a similar share in the early 1960s. In 1988,

there were nearly five hundred individual credit unions in operation (400 in the Republic and one hundred in Northern Ireland) with a total membership in the region of 850,000 and accumulated savings of nearly £500 million, of which an estimated £400 million related to the Republic.

## **Insurance and Banking**

The insurance industry in Ireland, which can also trace its origins to the early eighteenth century, has become more competitive since the 1960s partly as a result of acquisitions of a number of medium-sized Irish firms by foreign companies as well as significant additional entry into Ireland of such companies. About 20 per cent of insurance premium income now accrues to Irish-owned insurance firms. A feature of the insurance industry, which will disappear in the 1990s, is that insurance policies can only be sold by a firm that has a commercial presence in Ireland and is licensed by the Irish authorities. Improvements in the quality of assurance and insurance products that are receptive to customers have also helped to make the industry more competitive.

The insurance industry in Ireland has recorded a more rapid rate of growth since the mid 1970s than that experienced in a number of countries in the EC where, in contrast to banking and securities activities, the insurance industry has been protected from the full force of international competition. The higher rate of growth that occurred in Ireland was accompanied by major prudential problems in the 1980s in two Irish-owned insurance firms which between them account for about one fifth of the domestic insurance market.

Prudential difficulties have been experienced in the insurance industry from time to time over the past fifty years. In 1938, four small assurance companies (City of Dublin Assurance Company, Irish Life and General Assurance Company, Irish National Assurance Company and Munster and Leinster Assurance Company) revealed deficiencies, amounting to £1 million (equivalent to some £30 million nowadays) in aggregate, in their assets relative to their liabilities which were made good by the Minister for Finance. The Equitable Insurance Company was wound up in 1963 while the Private Motorists Protection Association was temporarily placed under Administration by the government in 1983 with a view to protecting policy holders and arranging for the gradual elimination of the deficiencies that had arisen. Six years later, that is, in 1989 the viable ongoing business of the PMPA was sold to Guardian Royal Exchange. In 1985, Allied Irish Bank wrote off nearly one quarter of its capital base at that time when its wholly-owned insurance subsidiary – The Insurance Corporation of Ireland plc – experienced substantial losses and was also placed and continues under Administration. The Insurance Compensation Fund was established in 1964 to meet certain liabilities of insurance companies that experience prudential difficulties.

Since the 1960s, deficiencies that occur in the assets of insurance companies are gradually financed by annual contributions borne directly by the private sector rather than by the authorities as occurred in 1938. Steps were taken in the 1989 Insurance Act to exclude corporate and externally issued policies from falling within the scope of any protection that may be provided in the future under the Insurance Compensation Fund. All of the customer compensation arrangements now in place in the financial sector (whether in respect of depositors with banks and building societies, holders of insurance policies and clients of stockbroking firms but not assurance policies in respect of which there are no specific compensation arrangements) are limited to providing comfort to the personal customers of these institutions which is in line with international practice.

Generous fiscal incentives have favoured savings with life assurance companies at the expense of savings with banks, other deposit-taking institutions, Unit Trusts and direct personal holdings of gilts and equities. The state has also promoted a major assurance company – Irish Life Assurance plc. This company was founded by the state some fifty years ago (by amalgamating in 1939 four Irish-owned life companies referred to earlier and the Irish business of five British life offices) and built up not far short of a 50 per cent share of the life assurance market in Ireland. This company has also been expanding abroad since the mid 1960s. It established its first area office in the UK in 1967 and by the late 1980s was deriving one third of its individual business annual premium income from there. In 1988, Irish Life Assurance acquired Inter-State Assurance Company, Iowa; this firm can write business throughout most of the American states. Consideration is being given by the authorities to the nature of the appropriate capital and ownership structure of Irish Life Assurance for the future. At this stage about 55 per cent of the premium income of assurance companies accrues to the Irish-owned firms.

Ownership inter-linkages exist between assurance and banking in the sense that Irish Life Assurance holds a substantial interest – in the range of 10 to 15 per cent of the issued share capital of both Allied Irish Bank and Bank of Ireland. Irish Life Assurance also has a 25 per cent holding in Irish Inter-continental Bank. Other life assurance firms operating in the Republic also hold bank shares in their portfolios. As regards banks owning assurance companies, Bank of Ireland established in 1987 a wholly-owned life assurance subsidiary while Allied Irish Bank has applied for authorisation to enter life assurance business. Banks are discouraged from owning general insurance firms as distinct from assurance companies and, at this stage, no bank owns an insurance company nor is there a case of a bank being owned by an insurance company. The marketing of insurance products and the ownership of insurance broking firms or agencies by banks is not discouraged as, in such circumstances, banks are primarily

involved on an agency basis and not in a principal capacity (which would entail onerous responsibilities).

Over the past two decades, but especially in the 1980s, the life assurance companies, both Irish-owned and foreign, have been playing an increasing role in the overall domestic savings market and now account for about half of it. While the protective-type assurance products are not close substitutes for deposits with banks, building societies and other deposit-taking institutions, the shorter term and reasonably liquid savings-orientated assurance products (described as unit linked funds) may be regarded as reasonably close substitutes for deposits and diversified personal portfolios of gilts, equities and other investments. Guaranteed income and growth bonds, investment bonds without guaranteed performance, single premium and more conventional regular premium savings policies – all supported by life assurance cover – were on offer in recent years in competition with medium sized savings in banks and building societies but also in competition with direct personal holdings of equities and gilts.

Following the 1986 and subsequent Budgets, some of these facilities, especially guaranteed income and growth bonds, have become less attractive. Competition in the 1990s between the domestic deposit-taking financial institutions and the assurance companies will take place on a more equal basis than in the 1980s. This is because a further movement towards a more equal tax treatment of all financial institutions, the enthusiastic promotion of collective investment facilities, the entry of banks into life assurance, and the marketing of assurance products by deposit-taking institutions and of some bank products by assurance companies.

In the 1990s, the assurance industry will be concentrating more on competition within the domestic industry itself and on the liberalising implications of EC directives for the European wide industry (which may become less fragmented through mergers) than on direct competition with the other domestic financial institutions and personal portfolios (including Unit Trusts) of gilts and equities.

A number of EC directives will gradually come into force over the 1990s which will allow a company to sell its products across national boundaries without having to have a commercial presence there or to be licensed by the authorities of the country concerned. A co-operative agreement entered into in mid 1989 among nine European assurance companies, including Irish Life Assurance, to establish a network between them for sharing and exchanging information and products etc. may be a tentative move in this general direction.

## **Securities Industry**

There have also been significant changes since the 1960s in the structures of both the stock exchanges in Ireland and their member firms which, in broad terms, may be described as the securities industry. There has always been close co-operation between the exchanges in Ireland and those in Britain. The Irish exchanges derived significant benefits down the years from participating in these highly developed international stock exchange arrangements. A loose agreement between the exchanges of Ireland and Britain emerged in 1965 when the Federation of Stock Exchanges in Great Britain and Ireland was established. This helped to achieve uniform minimum standards in relation to such matters as the issuing and publication of prices for securities, and qualifications of stock exchange members. It also allowed member firms of the exchanges to participate in a central client compensation fund that could be drawn upon in the event of the failure of a stockbroking firm of which there have been three such experiences in recent decades.

Steps towards consolidation within the Republic were taken in the second half of the 1960s and, in March 1971, all of the exchanges in the Republic – Dublin, Cork and other areas – came together to establish The Irish Stock Exchange. Within two years the exchanges in Ireland and Britain were formally amalgamated in 1973 under the title The Stock Exchange, with the exchanges in the Republic and Belfast being recognised as the Irish Unit and the Belfast Unit respectively of the London based exchange.

Major advances in communications technology, removal of barriers to capital movements internationally, more intense international competition and lower computing costs in the securities industry occurred from the mid 1970s onwards which resulted in a major reorganisation – known as Big Bang – of the securities industry in London in the mid 1980s. Arising from these international developments, The Irish Stock Exchange became part of The International Stock Exchange of the United Kingdom and the Republic of Ireland in 1986. This arrangement enables The Irish Stock Exchange to participate in a highly developed computerised system for quoting, clearing and settling transactions in equities.

However, one of the results of these changes in the mid 1980s is that there has been some weakening of the Irish connection with London as the large central

compensation fund no longer brings comfort to the Irish clients of stockbroking firms in Ireland. A new fund extending to Ireland, the Isle of Man and the Channel Islands has recently been established to provide cover to the personal clients of stockbroking firms in these areas. A further weakening of the relationship with London may arise as the supervision of The Irish Stock Exchange becomes more localised with the coming into effect of the EC Investment Services Directive by the end of 1992 and with the introduction of appropriate best international practices in determining the prices of Irish gilts and equities in the Dublin markets.

Apart from the amalgamation of the exchanges in Ireland since the mid 1960s and their closer association with what has been occurring in the securities industry internationally, there has been increasing concentration among the Irish stockbroking firms themselves. Prior to the mid 1970s over half of the stock exchange firms consisted of two partners. The number of such firms has fallen markedly since then with six multipartner firms now conducting most of the business of the stock exchange. This consolidation has been accompanied by major changes in the ownership of stockbroking firms since the mid 1980s. Banks are no longer prohibited from owning or participating in stockbroking firms of which a number of them in the Republic are now associated with or owned by banks.

With regard to gilts transactions, the stockbroking firms are confined to acting as agents for their customers with minimum commissions stipulated by the authorities. An implication of these arrangements is that there are no firms engaged in making a market in Irish gilts. In the case of equities, negotiable commissions are applicable and the stockbroking firms may act in a dual capacity, that is, acquire or sell equities on their own account as well as acting as agents for their customers. In acting on their own account or in a principal capacity, they would contribute to the marketability of the equities concerned. So far, the market making function is not a developed feature of the equity market in Ireland.

The market for government securities, which accounts for nearly ninety per cent of the overall turnover on the stock exchange, has increased enormously since the 1960s because of the very large amount of government borrowing since then. The market in equities has remained limited despite the revived interest since 1983 but, with the introduction of less well-established and smaller companies since 1986, a greater range and amount of Irish equities will be coming available in the decade ahead. By Summer 1989, the prices of Irish equities had recovered from the October 1987 Crash, and the equity market is now growing more rapidly than the gilt or government bond market.

Government borrowing is increasing more slowly than in the past as the excess of government expenditure over tax revenue is getting smaller. Companies,

however, are raising an increasing amount of funds by issuing shares because, in recent years, it has become more attractive to raise funds in this relatively liberal and perhaps less onerous manner rather than relying on the more confining and demanding conventional sources, particularly bank credit. International business conducted on The Irish Stock Exchange is increasing relative to domestic business. Foreign investors are acquiring Irish securities especially government bonds and Irish savers are also availing of the opportunity once again, following the liberalisation of exchange controls in 1988 and 1989, to diversify their portfolios by increasing their holdings of foreign securities.

The channelling of funds from savers to companies and the public sector by the issue of securities on the stock exchange is not a serious competitive challenge for the banks. This is because the main Irish holders of government securities (excluding the banks themselves) are the building societies, insurance companies and pension funds. These institutions compete directly with the banks themselves for the savings of their personal customers whose direct holdings of gilts are declining in importance because of tax incentives and cost advantages that nowadays tend to favour the institutional rather than the personal management of funds and portfolios.

Nor is the issue of equities a serious threat to the banks because so far the total amount of funds raised by issues of equities (excluding those issued by the banks themselves) is not substantial, and because the amount of equities directly held by potential bank depositors is relatively small. It must also be recognised that the banks probably welcome the lowering of the risk in their lending portfolio arising from the improvement in the capitalisation of Irish companies (which also raise funds by borrowing from the banks). Finally, the impact on the banks of a major reduction in the market for channelling funds via the banks from savers to borrowers, as a result of a relatively substantial increase in the amount of equities issued, would be cushioned by the fact that the banks now own or can acquire stockbroking or security firms. In turn, security firms are becoming more involved in the various ways to raise funds or invest savings and extending their advisory services on corporate restructuring.

### **Extending Abroad**

At the same time as foreign banks were creating a more competitive domestic banking environment, the two major Irish banking groups were gaining experience in expanding abroad and this is now reflected in the expected contribution, of the order of 50 per cent, to their profits from earnings outside the country. This increase in the international activities of Irish banks is additional to, and not to be confused with, the relatively rapid growth in their international banking business with non-residents that is conducted from offices located within the state, including the International Financial Services Centre.

Leaving aside for the moment their presence in Northern Ireland, both groups have established a foothold, in the 1970s, in the British retail banking sector where their branch network increased from no more than a few branches in 1970 to thirty in 1975 and to some sixty in 1989. The Bank of Ireland group entered into instalment-credit banking in the UK in 1978 by acquiring a small local bank and, in 1987, acquired another bank that specialises in mortgage finance. At this stage, the Irish banks, with around one per cent of the British retail banking market, have a larger share of that market than the other external banks who have directly established themselves there in local retail banking rather than relying solely on acquiring existing retail banking outlets.

In 1988 Bank of Ireland acquired a regional banking group in New Hampshire, USA. Allied Irish Bank had already entered domestic banking in the United States in 1983 through the acquisition of a major share in a medium-sized regional bank in Maryland. It acquired full ownership of it in March 1989. The two groups have also established themselves in the City of London and, since the mid-1970s, in New York and environs, and more recently, in other international financial centres – Singapore, Hong Kong and Sydney. In addition to these locations, the banks are represented in Brussels, Frankfurt, Jersey, Isle of Man, Cayman Islands, Chicago and Tokyo. One of the smaller Irish banks – Anglo Irish Bank Corporation – is also involved in instalment-credit and leasing in the UK where it has a local presence.

### **Northern Ireland: Changes in Banking Structure**

Finally, we recall what has been the nature of the changes in banking in Northern Ireland since the mid 1960s. There were significant mergers between the banks in Northern Ireland in the 1960s. The third and last of the clearing banks centred on Belfast was merged into the British clearing bank system when the Midland Bank took over the Northern Banking Company in 1965 and proceeded to integrate the Belfast Banking Company with it by 1970. Subsequently, in 1986, the Midland Bank established separate subsidiaries for the Republic and the Northern Ireland business of the Northern Bank and, in 1987, sold both subsidiaries to National Australia Bank – a major retail-oriented Australian bank.

The Ulster Bank, which had been a subsidiary of a UK clearing bank since 1917, became part of a wider clearing group – National Westminster Group – in 1968 with the amalgamation of its parent with another UK clearing bank. During the 1930s and 1940s all of the savings banks in Northern Ireland, except the Enniskillen Savings Bank, merged with the Belfast Savings Bank. In 1974 the Enniskillen and Belfast Savings Banks were merged to form the Trustee Savings Bank of Northern Ireland. This institutions changed its name once again in 1986 to TSB Northern Ireland plc when it became a fully-owned subsidiary with full banking status of the London-based and recently privatised Trustee Savings



Bank (Holdings) Limited. There were thirteen British based building societies in operation in Northern Ireland in 1988 compared with only two small locally registered societies. It is noteworthy that since the mid 1960s no major private financial institution operating in Northern Ireland – whether bank, building society or insurance company – was locally owned. This tends to confine the financial institutions in Northern Ireland to the local home market.

The structural changes in banking in Northern Ireland followed a similar pattern to what was occurring in the Republic of Ireland. Industrial or instalment-credit banking subsidiaries were established by the Northern Ireland clearing banks in the 1960s to compete mainly with the branches and subsidiaries of British industrial banks, some of which in turn were subsidiaries of British clearing banks that did not have clearing bank subsidiaries in Northern Ireland. Merchant banking subsidiaries were also established by the Northern Ireland clearing banks partly to avoid paying relatively high rates of interest across the board on deposits at their branches. Three banks from North America also opened branches in Belfast in the early 1970s but they subsequently withdrew. Apart from the actions of their subsidiary clearing banks in Northern Ireland, British banks did not directly establish merchant bank subsidiaries there.

The indications are that clearing banking business relative to other forms of banking activities are larger in Northern Ireland than in the Republic. This partly reflects the relatively large foreign bank presence and significant non-resident business of the subsidiaries of the clearing banks in the Republic. It also reflects the extent to which business firms in Northern Ireland have resort externally especially for non-clearing banking and related services.

Building societies and insurance companies, which played a larger role in Northern Ireland than in the Republic in the earlier decades of this century, continued to develop in Northern Ireland over the past twenty years along similar lines to those in the Republic. The number of building society branches in Northern Ireland rose from twenty eight in 1975 to one hundred and four in 1988. Nowadays, savings with building societies are about two thirds of those with the clearing banks compared with five per cent in 1960. The National Savings Bank, and the National Girobank, like the Post Office Savings Bank in the Republic, have not retained their market shares which, in aggregate have fallen to around 2 per cent. The TSB Northern Ireland has had the opportunity since the mid 1970s to move steadily towards privatisation with the substitution of private lending for holdings of government securities. This development is evolving much more slowly in the Republic where the role played by the trustee savings banks is much smaller than it is in Northern Ireland. The credit union movement is relatively strong in Northern Ireland as it is also in the Republic.

The indications are that competition between credit institutions in Northern Ireland, especially for retail business, will continue to increase. This is because

of the enlarged scope for the extension of services provided by building societies under the 1986 UK building societies legislation; the greater thrust behind the trustee savings bank since privatisation; and the introduction by the clearing banks of interest on current accounts. Each of the clearing banks in Northern Ireland independently sets its own levels of interest rates since January 1985 when the joint setting of interest rates was discontinued.

One of the main differences between the Republic and the Northern Ireland financial sectors is that locally-oriented financial markets did not evolve to any significant extent in Northern Ireland. Given the pattern of external receipts and payments of the Northern Ireland economy, it is probable that the passive nature of the financial markets in Northern Ireland has led to sizeable holdings of assets outside Northern Ireland by Northern Ireland residents. The banks in Northern Ireland are more liquid than in the Republic with a higher proportion of their resources being invested outside Northern Ireland. Furthermore, the indications are that the margin between interest received and interest paid by banks in Northern Ireland is larger than in the Republic where retail banking is more concentrated than in Northern Ireland. Other distinctive but related features of Northern Ireland are that it is not bearing a high per capita level of marketable public debt, especially vis-à-vis non-residents of Northern Ireland, and that it does not have an independent currency.

These features partly account for the absence of indigenous capital, money and foreign exchange markets in Northern Ireland. Broadly speaking, the banking system in Northern Ireland continues to be relatively retail and local in orientation and to centre its liquidity requirements on London as it is fully integrated into the UK financial system. This leads to outflows and the importation of financial-market services by the financial institutions. The non-bank residents of Northern Ireland probably spread their holdings of external assets more widely than residents of the Republic, in the form of claims on Britain, the Republic, the Isle of Man and other offshore centres.

### **Strategic Aims**

Irish banking has evolved over the past twenty years from relatively passive membership of the sterling area banking system with its liquidity centred on London. In the process, it has strengthened itself to face strong competition at home from foreign banks and from non-bank domestic financial institutions that were the beneficiaries of relatively favourable taxation arrangements and established a sound domestic base from which to extend abroad. Employment in banking and related services in the 1980s accounts for nearly 3 per cent of total employment compared with a figure of less than 1 per cent in the 1960s. It is estimated that in the late 1980s there were at least 22,000 employed in banks compared with nearly 2,000 in building societies, some 9,000 in insurance companies and somewhat over 500 in stockbroking firms.

A more competitive climate between the major Irish banks themselves has been emerging since the mid 1980s with their greater scope for setting interest rates independently and with their more rigorous pursuit of a group-oriented business strategy and an enhanced commitment to customer service. These developments are eroding the distinctions between their clearing, merchant and industrial banking activities that were promoted in the 1960s and integrating more closely the management of the retail, corporate, treasury and overseas activities of the banks. To summarise, the banks are currently pursuing their second major initiative in this century – the first being in the 1960s – to maintain and increase their share of the overall domestic savings market. Alongside these developments in the clearing banks, significant structural adjustments and changes of ownership have been occurring among the other banks operating in the Republic particularly since the mid 1980s.

The banks are responding to the growing competition between financial institutions by extending in a number of directions. They are becoming directly involved in stockbroking firms and to a limited extent underwriting issues of securities as the boundaries between banking and stockbroking or securities activities are eroding. Banks are also becoming much more involved, in a fiduciary capacity, in managing portfolios for pension funds, trusts, charities, and private clients, and in the marketing and management of collective investments such as unit trusts. Furthermore, they are also establishing assurance subsidiaries and marketing insurance products on an agency basis. The wide range of non-banking activities nowadays undertaken by banks will probably grow in relative importance in the future as barriers are lowered between different types of financial institutions. This may result in banks becoming major financial supermarkets in their efforts to increase their share of the overall market for savings and financial services.

The extent to which banks successfully establish themselves over time as financial supermarkets will depend also to a certain extent on the behaviour of their customers. Customers may be concerned that where a bank's interests and those of its customers conflict, the bank may operate against the customers. Moreover, customers may not wish to lose contact with a wide range of independent financial institutions. These concerns would be mitigated by the following:- greater competition between financial supermarkets; separate incorporation within the supermarkets of specialist financial services; strict barriers to the exchange of information about customers between the different areas of business conducted by the financial supermarkets; enhanced arrangements for investigating customer grievances; and the introduction of an agreed code of conduct for marketing financial products by all the financial institutions engaged in the provision of financial services.

The Irish banks have also been looking outwards particularly during the 1980s as banking became more internationally integrated and have established a significant presence abroad relative to their domestic activities. With the emergence of the single financial market throughout Europe in the 1990s all banks, and indeed all other financial institutions, now operating in Ireland must remain internationally competitive. This will call for a reduction in the relatively high interest and expense margins that exist in Irish banking and an improvement in the quality of their products required by their customers. Otherwise their shares of the Irish and European banking markets will decline – a development that would have a greater impact on the banks themselves than on their customers, who will have access in the years ahead to a wider range of external financial institutions.

Past experiences with international competition, and with takeovers and mergers, would suggest that competition that is not excessively aggressive and is conducted in an orderly manner tends to be beneficial to both bank shareholders, bank staff and bank customers. Over time, competition and the threat of being taken over improves operational efficiency, and leads to the introduction of innovations that provide customers with the international range of services that they demand at competitive prices.

It remains to be seen what will be the ultimate implications of international competition and the overall integration of financial markets, including the realisation of the single European market, for the future structure of Irish banking both in Ireland and abroad. We can be confident, however, that the strategic objectives of the dynamic and growing companies in the financial sector will continue to change and that their organisational structures, management capacity and global control systems will continue to evolve so that they continue to be successful in the rapidly changing international financial services industry. Whether financial institutions located in Ireland orient themselves towards the regional or specialised segments of the European financial sector, it would seem appropriate, in the context of EC regional development policy, that they be encouraged by, for example, the development of the International Financial Services Centre, to arrange their affairs so as to maximise the proportion of their value added that is located in Ireland.

In addition to these structural developments in recent decades, Irish banking also had to accommodate itself to significant changes in the role of the Central Bank.

### **Central Banking: Coming of Age**

It was recognised at the time that the Central Bank was established in the early 1940s that confidence in the currency would not be maintained if central banking

was confined solely to managing the issue and redemption of notes and coins and ensuring that those in circulation were fully supported by external assets. Thus, from the early 1950s onwards, the Central Bank found it necessary to express concern publicly about increases in public expenditure and bank credit that did not seem consistent over time with maintaining the value or purchasing power of the currency. It has continued to do so in subsequent decades against the background of a much deeper analysis of the causes of monetary instability and with varying degrees of emphasis, depending on the seriousness of the emerging monetary trends and their balance of payments implications. The Central Bank has also been developing over the years its techniques and methods for the purposes of implementing its monetary policy objectives. While monetary policy has always had the objective of minimising inflation, the manner in which this objective has been articulated and conveyed and the means used to realise or attain it have been continuously evolving.

It was the emergence of balance of payments difficulties in the mid 1950s that required the Central Bank to take its first steps in developing the techniques for implementing monetary policy. This occurred in the mid 1950s when the Central Bank responded positively to requests from the clearing banks to provide them with temporary accommodation at a time of a sharp contraction in their foreign liquid assets. Prior to the mid 1950s, adverse developments in the balance of payments did not impinge on the adequacy of the banks' liquidity or encashable assets which was at a comfortable level due mainly to the trade surpluses of earlier decades.

There was also a reluctance in the 1950s to allow Irish interest rates to rise in line with those abroad which had been increasing from the artificially low levels set at the beginning of the World War II. This attitude towards rising interest rates was accompanied by increasing government outlays for capital purposes which, at times, it was difficult to finance by borrowing from domestic sources other than banks. The need for the banks to hold foreign or external assets continued to be questioned in the 1950s, as it had been since the 1920s, without reference to the rate of return that they might earn if they were invested domestically. Furthermore, in the mid 1950s the banks' domestic lending was increasing at an unsustainable rate. These were the main features of the financial scene in Ireland around the mid 1950s.

### **Relying on Credit Guidelines**

It is not surprising that balance of payments problems emerged in the mid 1950s. The Central Bank played a major role in exposing the main causes of the difficulties, especially the unsustainable increase in bank credit that led to temporary borrowing by the banks from the Central Banks to meet their shortages of liquidity abroad. These experiences were accompanied by a sharp

tightening of fiscal policy and the Central Bank embarking on a more significant role than formerly in discussions and consultations concerning the responsibility of the banking system in financial and economic policy. A liquidity standard for the banks introduced in 1958. This specified a minimum level of external assets and balances at the Central Bank relative to their domestic resources, that is their current and deposit accounts.

Balance of payments difficulties developed again in the mid 1960s for a number of reasons and this led to a deepening of the influence of the Central Bank over the rate of increase in domestic bank lending. While the Central Bank had been relying on the voluntary co-operation of the clearing banks in managing their liquid assets relative to the movements in their domestic resources, it decided to strengthen its hand in summer 1965 at a time of contraction in the official external reserves. This followed a request from the clearing banks, in the light of the deterioration in their liquidity, for advice about the appropriate magnitude of the future growth in their credit. In the context of coming to grips with the external payments difficulties, the Central Bank took the opportunity to advise the banks about the appropriate magnitude of future increases in their domestic lending that exceeded the growth in their deposit resources (excluding that in the form of credit balances on current accounts). The Central Bank also embarked on consultations with individual banks about their direct contribution to the attainment of the overall credit policy objective.

Changes in interest rates that reflected international developments as well as quantitative guidelines were relied upon for the purposes of implementing credit policy for the next twenty years or so, i.e., up to the mid 1980s. A debate took place in the second half of the 1960s about the extent to which it was appropriate to continue to regard only the increase in bank lending that was in excess of the growth in domestic deposits as representing additional money arising within the country. Heretofore, deposits were not considered as part of the money in circulation as the emphasis, reflecting the state of development of the economy and the emphasis in monetary analysis, was on the motives for holding money for making payments rather than for the purposes of accumulating wealth.

There was a new dimension to this debate towards the end of the 1960s with the growing importance of the newly emerging banks. These recently-established banks were not only attracting some of the newly accumulated savings but, in addition, were diverting existing deposits away from the long-established clearing banks. It was considered that this competitive process was changing the character of deposits from representing long-term inactive savings or holdings of wealth to being closer to money held for transactions purposes as represented by the credit balances on current account.

In the light of these developments, it was decided at the turn of the decade to direct the Central Bank's credit advice towards the gross or total annual increase

in lending by all banks. For the early 1970s quantitative limits were also extended to inflows from abroad through banks as, in those days, it was considered that they were the main channels for mobile inflows from abroad and it had been feared that such inflows could easily become excessive in the lax international monetary climate that prevailed.

The quantitative credit guidelines on inflows had to be supported during the early 1970s with arrangements for the placing by banks of relatively low interest-bearing balances at the Central Bank to discourage excess inflows of funds from abroad through banks. Penal rates of interest for excessive borrowing from the Central Bank also had to be applied. International inflation, floating exchange rates, the oil crisis of 1973, and, of course, the growing domestic budget deficits from 1972 onwards, brought about the application of these specific measures with a view to limiting the growth in domestic bank lending. However, the credit guidelines were suspended in 1974 as domestic prices were being allowed to respond to the oil price shock of 1973 and as national economic policy was not oriented towards adjusting the economy to the real effects of the rise in fuel prices.

A major shift of emphasis was required in 1978 following the absence of adjustment to the 1973 oil crises, the sharp depreciation of the Irish pound in line with sterling in 1976 and the excessively expansionary final stance after mid 1977. The economy moved rapidly towards inflation of the order of 20 per cent, unsustainable external and budgetary imbalances of over 15 per cent of GNP and inordinate annual rates of increase of over 30 per cent in domestic bank credit. Credit guidelines were reintroduced after a lapse of a few years by the Central Bank and applied with much greater vigour than heretofore.

Additional penalties on banks had to be introduced in the form of relatively low interest-bearing balances at the Central Bank, equal to the excess of lending over that advised, in order to give banks an incentive not to exceed the quantitative limits placed on their lendings. It will be of interest to see what form the instruments of credit control will take as monetary integration progresses in Europe. The changes over the decades in the orientation and approaches to implementing monetary policy partly reflected the structural changes that were occurring in the banking system. They also reflected shifts in the orientation of monetary and financial analyses to take account of the changes in emphasis and the findings of monetary research. The credit guidelines were not extended to lending to the Exchequer which became automatic and proportional to the growth in the banks resources following the introduction of the secondary liquidity ratio in 1972.

Despite the anti-competitive nature of such guidelines, they were applied up to the mid 1980s by which time the price of oil and the international rate of inflation

were substantially lower, the balance of payments deficit was significantly reduced and the rate of increase in bank lending was no longer a threat to stable monetary conditions. Since then, the direct approach of using credit ceilings for the purposes of implementing credit policy has been placed in suspension and, currently, the Central Bank is relying on indirect methods, that is, on the management of the movements in external reserves, bank liquidity and interest rates in implementing monetary policy.

This shift in focus partly reflects the international diversification of portfolios and the growing mobility of capital not only across frontiers but also between different domestic financial institutions. It also reflects the more widespread appreciation that the efficient control of movements of funds is through timely variations in the prices at which financial assets are traded or exchanged. However, the effectiveness of full reliance on the indirect approach to the implementation of monetary policy both in Ireland and in a number of other countries has not been fully tested in highly inflationary circumstances such as prevailed from the late 1960s to the early 1980s.

### **Localising Bank Liquidity**

At the same time as direct quantitative measures were being applied, the Central Bank had also been developing its capacity to influence indirectly bank lending. This indirect approach evolved more slowly than the direct quantitative methods as it depended on the rate of development of the domestic financial markets. The Central Bank gave its full support to this over the years, including the establishment of a committee of inquiry in 1967 to advise on future developments in the money market. The change of emphasis in the 1980s reflects the innovations that have been made in Irish financial markets since the mid 1960s but especially since the decision to join the EMS in the late 1970s.

The first indirect steps by the Central Bank to managing bank liquidity occurred in the mid 1950s when it temporarily accepted domestic paper from the banks and supplied them in turn with external balances that were used to meet their adverse clearings of cheques abroad. This was followed in 1958 by the first positive approach by the banks to building up domestic liquidity when they agreed to maintain their domestic cheque clearing accounts at the Central Bank rather than retaining balances in London for this purpose.

Another move in this direction occurred in 1964 when the Central Bank was empowered to pay interest on deposits that the banks themselves placed with the Central Bank; this led to the Central Bank providing a further addition to the level of balances that the banks retained at the Central Bank. Exchequer financing problems and balance of payments difficulties in 1965/66 led to the Central Bank providing a relatively large level of temporary accommodation to the clearing banks at the same time as credit guidelines were being tightened



and Exchequer borrowing (from the Central Bank, the International Monetary Fund and the external capital markets) was being embarked upon to finance public capital expenditure. Steps were also taken to exclude liquidity acquired by rediscounting bills with the Central Bank when computing the Central Bank ratio. The combination of these steps helped to prevent a serious reduction in the level of non-borrowed domestic bank liquidity which was being built up slowly since 1958.

In 1967, about one third of the external monetary reserves of the country, or somewhat over one fifth of the banks' domestic current and deposit accounts, continued to be held by the clearing banks in the form of foreign liquid assets. However the centralisation of bank liquidity at the Central Bank advanced rapidly in 1968 and 1969 with the lead being given by the Central Bank itself. This occurred in the wake of the 1967 devaluation of sterling and the concerns about inflation in the UK; the recognition internationally that the days of the sterling area were numbered; and the accompanying steps to diversify the sterling external reserves by transferring them to the Central Bank for investment in a wider range of currencies. The centralisation of bank liquidity also occurred against a domestic background in which the banks were taking up tranches of government paper annually which were not marketable.

As a result of these developments, the role of the Central Bank in the management of bank liquidity was rapidly extended, especially in 1969, when the Bank arranged for the transfer to it of the remaining external reserves of the banks and simultaneously provided a wide range of short-term deposit facilities for banks. Thus, by the end of the 1960s, the management of bank liquidity had been switched from London, where it had been centred for at least the previous 150 years, to Dublin where money and gilt markets were evolving. The conversion of the banks' sterling liquid assets into Irish-pound denominated liquidity in the second half of the 1960s prepared the way for the break in the link with sterling in 1979. This was achieved by the virtual elimination of a major mismatch between assets and liabilities expressed in sterling that, at least in strict legal terms, had existed in Irish banking since the late 1920s. This occurred when the banks' domestic liabilities and assets were expressed in Irish pounds at the same time as their external liabilities and assets remained expressed in sterling.

### **Developing Financial Markets**

The main events in the Irish gilt market in the decade prior to the 1970s were the issue of the annual national loan for public subscription and the occasional negotiations initiated by the government with the clearing banks for the uptake by the banks of an issue of government securities. Such negotiations became more frequent in the second half of the 1960s with the growth in public capital

expenditure. In those days gilts were mainly held to maturity rather than switched or traded to any significant degree as the proportion of gilts or bonds held by institutions and non-residents was relatively low. It was against this background that the Central Bank began to take steps to develop the domestic financial markets at the same time as private initiatives were leading to the emergence of the inter-bank market in Irish pounds.

The Exchequer Bill market was improved from 1969 onwards when the Central Bank assumed responsibility for the monthly issue of bills to the clearing banks and subsequently drew the recently established banks and other domestic financial institutions into the Exchequer Bill market. A weekly tender for Exchequer Bills was subsequently introduced in 1980 with the Central Bank standing by to buy and sell outstanding Exchequer Bills at prices that reflect current money market interest rates. Improvements in the variety, availability and marketability of government paper were gradually introduced in the 1970s which embraced short, medium and long-dated gilts with both fixed and variable rates of interest. In the 1980s, there have been further improvements in the depth and liquidity of the domestic gilt market with increasing turnover and rapid growth in the secondary gilt market, especially since the mid 1980s.

Liquidity ratios were formally established in 1972 which consolidated the substitution that had already occurred, of domestic for foreign liquid assets by requiring all banks to hold a specified proportion of their current and deposit accounts in balances at the Central Bank and in Irish government paper. The clearing banks ratios were reduced in 1979, following the impact of the inordinate and unsustainable increase in domestic bank lending in the late 1970s, and the accompanying large build up of indebtedness by the clearing banks to the Central Bank, which could not have been reversed without a major contraction in the level of bank lending.

No changes were made in the 1980s<sup>6</sup> in the liquidity ratios which continue to underpin the banks' domestic liquidity. However, the appropriateness of the arrangements, against the background of the changes in the 1980s in the domestic financial markets, the methods developed over the 1980s for managing bank liquidity and the need for a similar approach to liquidity ratios throughout the Europe, is being increasingly questioned but without reference to the operational needs of monetary policy and ongoing prudential liquidity requirements.

The Exchequer Account was transferred from the Bank of Ireland to the Central Bank of Ireland on 1 January 1972 and steps were also taken between 1969 and 1974 to transfer the registers of government securities to the Central Bank. In 1974/75, the Central Bank also entered into arrangements to introduce an overdraft facility for the Exchequer to enable it to bridge short-term gaps during

the year between Exchequer receipts and expenditure. These changes were also consistent with centralising the management of the banks' liquidity in the Central Bank.

The centralising and diversification of the external reserves also led to the gradual development of the Dublin foreign exchange market. In 1968 the Central Bank began purchasing surplus foreign currencies (other than sterling) directly from banks and, by 1970, it was also meeting their demands for foreign currencies. With the channelling of the foreign-currency business (other than sterling) through the Central Bank, finer rates of exchange were negotiated but dealing in foreign currencies between the banks themselves was not being facilitated.

In order to encourage such dealings, the Central Bank took steps in September 1977 to promote interbank dealing in foreign currencies. An important outcome of these changes, over the ten years to 1978, was the development of local expertise which facilitated the undertaking of market-making in the Dublin foreign exchange market from 1979 onwards. A market-oriented forward foreign exchange market for the Irish pound emerged at the same time following initial support from the Central Bank which, for a short period of time, bore some of the risks involved. The Dublin inter-bank markets in both Irish pounds and foreign currencies, which had been developing throughout the 1970s, also matured in the wake of the break in the fixed link with sterling.

A stage has been reached in Ireland where the foreign exchange and domestic money markets are reasonably well developed. Efficient and resilient markets are useful for judging the impact of short-term actions by the Central Bank. More importantly, they help to transmit the medium-term influence of monetary policy throughout the economy with a view to securing broad price stability over time.

### **Responding to Implications of EMS**

The exchange market developments referred to above occurred under the guidance of the Central Bank especially in the period following the decision to join the European Monetary System. Sterling was treated on a par with the other major foreign currencies for the purposes of determining the appropriate magnitude of banks' holdings of foreign exchange assets and also for the purposes of facilitating the introduction of foreign exchange market-making arrangements. Thus, since the early 1980s, the Dublin foreign exchange market is fully integrated into the international foreign exchange market in the context of membership of the European Exchange Rate Mechanism. It operates within the constraints of the exchange controls on short-term capital movements that were introduced in 1978, when Ireland decided to join the European Monetary System. These exchange controls will be phased out by end 1992.

The break in the link with sterling also resulted in the introduction of a wide range of techniques by the Central Bank for the purposes of intervening in or influencing the financial markets and managing the liquidity of the banking system. Up to 1979, the daily settlement of banks' residual short-term liquidity continued to be associated with residual transfers of funds to and from London. However, following the break in the link with sterling in March 1979, the Central Bank developed its connection with the domestic money market a stage further by establishing in July 1979 a residual overnight facility for banks known as the short term facility. Settlement of banks' positions at the end of each day is now conducted at the Central Bank by transfers between the banks across their operating accounts and by variations in the levels of drawings on the short term facility and in the levels of bankers' overnight balances with the Central Bank. This is known as the Daily Inter-bank Settlement facility which was established by the Central Bank in December 1980.

Other significant innovations in the manner in which the Central Bank provides or withdraws domestic liquidity were to follow in the early 1980s. Arrangements were put in place between the Central Bank and the banks for contracting or expanding domestic liquidity at the initiative of the Central Bank through the use of temporary swaps of foreign currency. Another major innovation was the introduction in 1983 of domestic gilt sale and repurchase arrangements to be conducted at the initiative of the Central Bank to provide or absorb liquidity through the extension or cancellation of short-term loans to banks.

The break in the link with sterling and membership of the EMS opened up another chapter in the history of the evolution of the Central Bank. It led to the full integration in the 1980s of what had been happening gradually on three fronts since the late 1960s, namely the domestic orientation of the management of bank liquidity, the development of the local financial markets, and the underpinning of ceilings on bank credit with penalties derived by reference to movements in the local interest rates. In other words, the Central Bank's techniques for influencing or intervening in the foreign-exchange market as well as in the domestic money market were developed rapidly following membership of the EMS and, by the mid 1980s, had been fully tested.

### **Prudential Supervision**

The rapid rate of structural change in the banking industry over the past twenty five years had prudential and risk management implications which the Central Bank also had to address. In 1965, the Central Bank indicated, in anticipation of the major structural changes in banking in the second half of the 1960s, that it regarded consultation with it as a 'preliminary step in connection with every proposal for the entry of an external institution into banking business in Ireland'. It also made it clear that 'any external bank establishing itself in this country will

be expected to show itself responsive to local conditions' and 'to the requirements of public policy in Ireland'.

The Central Bank also endorsed the mergers between the clearing banks in the mid 1960s and expressed 'the hope that they would contribute to a more economic and competitive organisation of Irish commercial banking'. At that time also the Central Bank recommended legislation relating to the definition of banking, the licensing of banks and the designation of a bank-licensing authority with discretionary powers. Despite the substantial entry into and significant structural changes in the banking industry since the settled days of the early 1960s, the number of bank failures has been confined to two local institutions of negligible magnitude: one was the Irish Trust Bank Limited, which occurred in 1976, and the other was Merchant Banking Limited in 1982.

The legislative proposals mentioned above were incorporated in the 1971 Central Bank Act and on 1 April 1972, the forty five existing banks were licensed by the Central Bank. The banks were required to have regard to the provisions and implications of the 1971 Central Bank Act and to meet various non-statutory standards and requirements set down by the Central Bank. Since then, these standards have been revised and updated on a number of occasions to reflect the changing banking environment both at home and abroad. The supervisory role, as conferred on the Central Bank under the 1971 Act in the interest of the orderly and proper regulation of banking, has been evolving since the early 1970s. It is continuing to do so with the additional wide-ranging legislative support provided by the 1989 Central Bank, Building Societies and Trustee Savings Banks Acts and the increasing range of EC directives that will be in place after 1992.

Banks and other deposit-taking institutions are unique among financial institutions in the sense that a high proportion of their assets are difficult to assess and value as they are not marketable while, at the same time, all of their liabilities are repayable on demand at predetermined fixed monetary values. In view of this feature of banks and also because they are the main collectors of small savings and administer the cheque payments systems, the maintenance of the confidence of the public in their ability to meet their liabilities confers significant social benefits on society.

A bank's capacity to meet these responsibilities to society is ultimately related to its overall financial condition, i.e., the quality of its assets and to its capacity to earn profits to remunerate its minimum capital requirements. With this in mind, the Central Bank sets prudential standards for banks. An important objective of these standards is to discourage individual banks from undertaking inappropriate risks by diversifying and avoiding undue concentrations of lending risk, by holding a specific level of liquid assets; by adequately capitalising themselves;

by putting appropriate risk management procedures and controls in place; and by maintaining appropriate management capacity.

The Central Bank collects information from banks to facilitate it in monitoring a bank's adherence to the supervisory standards, carries out on site inspections and, twice yearly, reviews the control systems and performance of each bank with its management. Since supervision is not designed to eliminate reasonable risk bearing it is appropriate to recall that the ultimate responsibility for preserving the soundness and safety of a bank rests with its directors and management.

With the rapid rate of change that is occurring internationally in the structure of banking and in the increased degree of risk to which banks are exposed, major international efforts are being made to raise supervisory standards. The emphasis is on having higher risk weighted prudential standards applied internationally while, at the same time, avoiding distortions in respect of competition between banks, the location of banking activities and between the different types of business conducted by banks. The standards and practices applied in Ireland continue to evolve in line with best practice in the major industrial countries, particularly in the European Community. Risk based capital adequacy requirements for banks, which are related to a bank's on and off-balance sheet assets, were introduced in mid 1989 for banks incorporated in Ireland in anticipation of the coming into effect of EC directives. Similar capital adequacy requirements have been introduced in Spring 1990 for the Building Societies and Trustee Savings Banks.

The Central Bank has had a relatively short period of relevant experience in carrying out its full range of responsibilities. The rapid evolution of central banking in Ireland over the past thirty years or so has been associated with the most serious monetary disturbances and most significant structural changes in banking – large price increases, high volatile interest rates, fluctuating exchange rates, rapid rate of structural change and increasing exposure to risk – experienced in Ireland since the time of the Napoleonic Wars and the early decades of the nineteenth century. Some of the monetary disturbances arose outside the economy and were to a large extent unavoidable. However, avoidable domestic developments, in particular the emergence of large budget deficits which led to major external imbalances and relatively high levels of public debt expressed in foreign currencies especially vis-a-vis non-residents, made a major contribution to the monetary instability experienced over the fifteen-year period between 1971 and 1987.

Apart from these adverse experiences, it is noteworthy that the development of the Irish economy has advanced more since the 1950s than over the previous century and a half. However, it is not all that surprising that it was during adverse

domestic monetary conditions, together with the experiences arising from ending the fixed link with sterling and those associated with the major structural changes in banks in recent decades that led to central banking reaching maturity in the Republic. The experiences of recent decades have also prepared the way for full participation by the Central Bank in the evolving European central banking arrangements which will gain momentum in the 1990s.

### **Northern Ireland: Banking and the Authorities**

Broadly speaking, banking in Northern Ireland was not brought within the direct influence of the monetary authority, namely the Bank of England, before the early 1970s when similar liquidity requirements for banks were introduced in both Britain and Northern Ireland, where their application was less onerous. Again, in the early 1980s the revisions to the liquidity arrangements in Britain were not applied with full vigour in Northern Ireland where the banks are being required to hold only half the level of liquidity (in the form of non-interest bearing balances at the Bank of England) compared with banks in Britain. Thus, since the early 1970s, a more direct interest has been shown by the Bank of England though the Northern Ireland banks did not have to adhere to the quantitative limit on the growth in bank lending applied in Britain during the 1970s. As experienced also in the Republic, this led to some bank lending that would have been booked in Britain being reflected in advances to non residents by the Northern Ireland banks. The relatively rapid growth in bank lending in the 1970s by the Northern Ireland banks was partly funded from the London inter bank market.

The main thrust of monetary and interest rate policy in Northern Ireland comes directly and continuously through external financial markets and through changes in the magnitude of the liquid assets of the Northern Ireland banks held outside Northern Ireland. What this means in effect is that the level of, and changes in, interest rates in Northern Ireland have been following without delay those in the sterling markets in London. It also means that the liquid assets of banks and other financial institutions in Northern Ireland have continued to consist primarily of sterling claims on the London financial markets, rather than on local institutions, as one would expect with full monetary integration between Northern Ireland and its main trading partner, namely Britain.

Finally, it is appropriate to mention that, since 1979, the banks in Northern Ireland fall fully within the scope of the Bank of England's evolving supervisory arrangements and that the other major financial institutions or activities in Northern Ireland are supervised by appropriate British supervisory authorities or by reference to the supervisory standards applied in Britain. Thus, where relevant, the major legally underpinned changes in the supervision of financial activities that were introduced in Britain in the 1980s were also extended to Northern Ireland. Examples of this were the transfer from 1 January 1987 of

supervisory responsibility for building societies registered in Northern Ireland to the Building Societies Commission in London and the application of the provisions of the Financial Services Act 1986 to Northern Ireland institutions. Full financial integration with Great Britain over the years has resulted in a greater proportion of the financial services consumed in Northern Ireland being provided from outside its economy compared with the experiences of the Republic where, in recent decades, the domestic production of financial services, including those exported, has been playing a larger role in the economy.



## **PART III : TOWARDS THE TWENTY-FIRST CENTURY**

### **1990s and Beyond**

While one cannot predict the future, present tendencies evolve into the future. The emphasis here is on the longer-term perspective, that is, on the general direction in which the banking and other financial institutions are currently moving rather than on the by no means less important shorter-term concerns that require immediate attention. Such concerns include making the most of the opportunities being offered by the emerging single market in Europe; establishing IFOX – the recently launched Irish futures and options exchange; reforming the operation and supervision of the Stock Exchange in Ireland; developing the International Financial Services Centre; and implementing the significant body of legislation, both domestic and EC, relating to the supervision of all credit institutions, securities and investment activities and the insurance industry that is being finalised and enacted in advance of 1992. Financial institutions will continue to specialise in extending credit, managing financial savings, providing payments services, processing financial information, offering financial advice and acting as custodians of financial assets but the manner in which these activities are performed will continue to change.

### **Future Payments and Savings Facilities**

Historical experience indicates that privately-issued money eventually comes under the control of the authorities who become involved in producing it and determining the total amount that it is desirable to issue. This has happened in the case of coins and currency notes over the centuries. Even as far back as 1500, privately-owned mints were prohibited from striking coins for the private sector. Similarly, during the past 150 years, most privately-owned banks have had to relinquish the right to issue their own currency notes or continue to do so provided the profits accrued to the state. Control over production and access to the resources and profits from issuing notes and coins; the promotion of confidence and uniformity in the composition of the currency; fostering efficient arrangements for effecting payments; and having an adequate supply of money to support non-inflationary economic growth have been the main reasons why the provision of the currency has come under the direct influence of the state. The same issues will be to the fore when the development of integrated European-wide central banking arrangements gains further momentum.

A feature of the evolution of the financial systems over the centuries is that innovations in financial products result in the more recently introduced payments and savings facilities growing more rapidly than the longer-established facilities. Coins and currency notes have been declining over the decades as a proportion of the total means of payments as a result of the relatively rapid growth of current and deposit account money. In recent times, substitutes for credit

balances on current and deposit accounts have been emerging rapidly and are likely to gain momentum in the decades ahead.

It may not be too far-fetched to suggest that in the early decades of the next century, money in the form of credit balances with financial institutions that is circulated by the widespread use of multi-purpose prepaid plastic cards may be regarded as the 'small change' of the economy. Furthermore, a new form of banking institution may emerge with the simultaneous extension of credit and provision of general-purpose prepaid plastic cards to those with a demand for this combination of facilities. Moreover, money in this form may be produced and issued by reference to public utility or public interest standards rather than by private institutions whose motivations are primarily technological and profit oriented. The desires and attitudes of the past – identified above – that brought and retained the production and issue of notes and coins under the influence of the authorities over the centuries will probably continue to prevail and determine how the 'small change' of the economy is produced and issued in the opening decades of the next century.

In the years ahead, central banks will probably acquire extended responsibilities that will require them to concentrate to a greater extent than heretofore on the implications of innovations in the financial markets; to develop new techniques for managing the growth of the technologically-based means of payments; and to assess the impact of the innovations in payments methods on the level of spending. Central banks will also have to concern themselves about the reliability and integrity of the clearing and ultimate settlement arrangements associated with securities and other financial assets and with the technologically-based payments systems of the future. One can conceive of payments systems that lead to the synchronisation of the payments and receipts associated with the exchange of income and assets. In such circumstances, money would become redundant.

The realisation of this is a long way off because of the inherent vulnerability of settlement and payments systems. There will be an ongoing concern in society by those receiving payments that those initiating the payments will have the ready capacity to give instantaneous financial and legal effect to them. Consequently, for quite some time to come, the bulk of transactions will continue to be effected by conventional means of payment in which people have confidence that the payment converts into an asset whose acceptability is guaranteed throughout society. In the meantime, reliable technological developments that reduce the costs, time required and inconvenience of effecting widely-acceptable methods of settlement and payment, both domestically and internationally, are to be welcomed. However, the most efficient computer-based private sector settlement and payment facilities will require the ultimate support of central banks for a long time to come if society is to continue to maximise the benefits to it of widely or generally acceptable monetary means of payments.

The tendencies mentioned above could result in the credit balances on current, deposit and analogous accounts that are actively used in effecting payments evolving towards a position in which they have the backing of the state. Similarly, the unutilised value of multi-purpose prepaid plastic cards may also evolve towards a position in which they have the support of the state. This would be because of concern about the ultimate quality of the means of payment used in society which, in the past, led to state backing for coins, notes and indeed, for the banks' deposits with the Central Bank. Such a development could have significant implications for the future structure of the banking institutions, including associated card-issuing facilities, in the private sector. It could channel a significant part of their business closer to the non-bank financial institutions and into securities-related areas with the central bank being less concerned about their commitments and ability to discharge their liabilities in respect of these activities.

Furthermore, fixed-valued claims other than coins, notes and balances embodied in or associated with the technologically-based payments arrangements may become relatively less important. Savers may be using an extended range of variable-value savings facilities, offered by a wide variety of financial institutions, to maximise the benefits from diversifying their financial assets. At the same time, borrowers may be using a greater variety of financing techniques and cultivating a wider range of sources of funds with a view to minimising their funding costs. Indeed, banking as we know it today may not be easy to recognise in the opening decades of the next century.

### **Credit and the Creation of Money**

A recurring international debate since the beginning of the nineteenth century, both in the professional literature and among policy makers, is the issue of whether or not newly emerging financial arrangements and institutions have the capacity to create additional money by extending credit. Apart from the Central Bank, the banks are the only existing credit institutions that are officially recognised as having the capacity to create money. Total lending by banking institutions is regarded as adding to the stock of money in existence even though part of bank lending only results in financial intermediation, that is, the reintroduction of money into circulation that had already been withdrawn through the accumulation by savers of credit balances with banks.

Another way of looking at this process is that matching increases in customers' borrowings from and deposits with passively oriented banks that are not associated with significant changes in borrowers' perceptions towards risk or in savers' preferences, may be regarded as neutral financial intermediation. But matching increases in bank lending and deposits that arise from deliberate policy initiatives by banks to increase the risk they undertake and that lead to a greater willingness by bank customers to increase their borrowings and holdings of deposits, may be regarded as the genuine creation of money by way of lending, rather than neutral intermediation as described above. Changes in the state of confidence and attitudes towards credit-worthiness go a long way in

helping to distinguish between what is financial intermediation and the creation of money through the extension of credit.

However, one does not know where to break into the circle. In practice, it is impossible to distinguish between the element of bank lending that is neutral in its impact on the amount of money in circulation and that part which leads to an increase in it. It is because the latter element is regarded, in the light of experience, as being significant in the case of banks that monetary policy concerns itself primarily with the growth in bank lending rather than with a wider range of lending or borrowing facilities.

With the evolution of the financial sector, an increasing variety of financial institutions may be coming to the fore. The new institutions may increase in size and extend credit with increasing confidence in their ability to finance simultaneously part of it by attracting savings, especially if they offer savings facilities that are also used more extensively in effecting payments. In this manner, they will probably develop the capacity to influence independently the level of national spending especially at the time of a relatively rapid rate of growth in their lending.

From the point of view of the implementation of monetary policy, the more recently-established or more rapidly growing institutions will be eventually considered as equivalent to the longer-established banks. The following are past examples of this type of development in Ireland: the incorporation at the end of the 1960s of clearing bank lending that was matched by increases in their domestic deposit liabilities within the scope of credit policy guidelines; the placing, around the same time, of lending by the recently launched or established banks on a similar footing to that of the clearing banks for monetary policy purposes; and, in the last century, the placing of limitations in the 1840s on the issue of private bank notes unless backed by gold.

Looking to the future, building societies, the Agricultural Credit Corporation, the Industrial Credit Company, trustee savings banks and other non-bank deposit-taking institutions may evolve in such a manner. They will probably be considered as having the capacity to create additional money by extending credit, especially if regarded as a single group of institutions, with the result that it may be appropriate to bring them within the direct scope of monetary policy. This may be because of their enhanced ability to influence the process of creating money, their contribution to the provision of facilities for effecting payments and their potential capacity to rely excessively from time to time on the short-term lending facility of the Central Bank.

It is probable that a debate about the respective roles and influences of banks and other credit institutions in the economy will be reopened during the 1990s. This will arise as the frontiers of what constitutes banking activity and the capacity to create money are pushed outwards, as occurred on a number of previous occasions over the past two hundred years.

## **Securities Activities: Monetary Implications**

Apart from the increasing variety of financial institutions, there is an additional development occurring as wealth in the form of money and financial assets is accumulating. The management of financial assets is growing in importance and different types of financial assets or securities are becoming more marketable with the evolution of the markets in financial assets. Markets in diversified financial assets issued by a wider variety of borrowers will probably be a more important feature of the financial sector by the beginning of the next century. The purchase and sale of existing assets, that is asset switching, will probably continue to be regarded as neutral in its effects on the supply of money but the liquidity or ability to be readily converted into cash of such securities may be enhanced with more competitive conditions for making markets, trading and determining the prices of securities. However, in the 1990s the emphasis will probably be on security selection and international diversification of portfolios over the medium term rather than concentrating on short-term trading that is motivated by the emergence of small temporary differences in prices of securities, as was the experience when prices of most securities were increasing simultaneously in the 1980s.

A debate could also emerge, alongside the bank/other credit institutions debate, about the monetary implications of the growth of the stock of marketable securities that facilitates the by-passing of the banks and other credit institutions in the channelling of funds from savers to borrowers. A relatively rapid increase over a short period of time in the diversified stock of marketable domestic securities in existence may be considered, up to a point, as having some money-creation characteristics as referred to in earlier paragraphs.

This might well be the situation if securities were being issued and widely distributed with enthusiasm, supported by market-making arrangements and held by investors with a high degree of confidence that ultimate settlement would occur within a few days. We should not be completely surprised if such developments came to be regarded in the opening decades of the next century as capable of making a small independent contribution to increasing the stream of spending in the economy. The definition and identification of what is mainly credit creation, intermediation, banking and non-banking financial activities will continue to be elusive in the decades ahead, especially with a growing proportion of the domestic demand for these services being accommodated from abroad.

An increase in exposure to risk, (by way of, for example, large exposures, extended leverages, multiple ranges of activities and wider gaps or longer distances between primary savers and ultimate borrowers), will accompany the technology developments, financial innovations, complicated institutional growth and the more competitive conditions being suggested above. Completion should lead to an all round narrowing of margins throughout the

financial sector and to greater concentration within it. Thus, ongoing changes in the supervision of the financial sector, as has been occurring, will continue to be necessary as the financial sector evolves along the lines discussed here.

### **Supervisory Requirements: Specialisation and Co-operation**

The main objective of supervision is to avoid systemic instability at the same time as the benefits of innovation and the evolution of the financial sector are realised in an internationally competitive environment. While significant changes will occur in the supervisory arrangements against the background of EC directives to be introduced in the early 1990s, the emphasis here is on the need for continuity in the evolution of supervision to keep pace with the ongoing changes that will occur in the financial sector. The indications are that there will continue to be three main areas within the financial sector which will require specific supervisory skills and capacity. These are now discussed with a view to giving a broad picture of the desired evolution of supervisory requirements. In reality, these requirements will be much more complicated with the emergence of across-frontier financial supermarkets that, in turn, may be only one element of multi-purpose world-wide holding companies.

Firstly, the banks and other credit institutions that accept deposits, manage the payments systems, extend credit and create money, should continue to be supervised by the Central Bank because of the nature of their activities. Apart from the extension of the Central Bank's supervision to all credit institutions, greater emphasis will need to be given in the years ahead to the supervision of the provision of plastic-card money. Supervision of credit institutions will also need to keep evolving as these institutions develop further towards becoming financial supermarkets themselves and part of wider financial groupings.

This will entail the extension of supervision to the growing range of activities of the credit institution itself and its subsidiaries; to the activities of the holding company of which the credit institution itself is a subsidiary; and to sister companies that are also subsidiaries of the same holding company as the credit institution itself.

Despite a growing proportion of the assets of credit institutions becoming more marketable and less of their liabilities being repayable on demand at predetermined fixed values, it would seem appropriate also that credit institutions continue to have the support of the temporary lender of last resort facility. Such a facility should continue to be regarded as a safety valve to avoid the excessively costly adjustment of otherwise solvent credit institutions. Given the appropriateness of a central bank avoiding the provision of temporary public support to a wide range of non-credit financial institutions, securities firms and other non-bank financial institutions, the lender-of-last-resort-facility should be confined to the credit institutions with an inherently large non-marketable portfolio and with an indisputable capacity to create money by granting credit.

The second main area within the financial sector that seems to stand out is insurance. It may be necessary to keep this area separate as significant risks, which are not readily diversifiable, will continue to be centred in this part of the financial sector. While the savings facilities provided by banks and life assurance companies will probably lead to a blurring of the distinction between these institutions, the management of the liquidity needs of assurance companies is less demanding than in the case of banks because of the relatively longer-term contractual nature of savings in the form of life assurance. However, it is likely that pure or general insurance business and banking will continue to be so different as to require separate supervisory arrangements.

The market value of a bank's assets is not as predictable as those of a general insurance company. In valuing their assets, banks must rely mainly on their own ability to predict and measure the capacity of their customers to repay, whereas insurance companies can draw to a greater extent on the outside markets as an aid in valuing their assets. On the other hand, the withdrawals of cash or calls upon the liabilities of a bank are more predictable than those on a general insurance company. This would be particularly the case if the latter concentrated on the larger and more unique risks rather than on the more generalised smaller risks that are widespread throughout society and amenable to reasonably frequent review. Insurance companies that underwrite large risk business can be confronted with major claims that are very difficult to predict both in respect of magnitude and timing. Such claims could fully absorb not only the cash flow from ongoing business but also lead to the sale of substantial assets thereby weakening the backing for the future commitments to policy holders.

The predictability of a bank's liabilities is related more closely to savings-motivated behaviour than are the claims on a general insurance company. In the case of general insurance companies, the exercise of certain types of claims on them can be spread unevenly and unpredictably over a number of years because of the very nature of certain types of insurance risks that are not easy to recognise in advance and which cannot be diversified or spread to any substantial extent. This is because the exercise of claims on insurance companies depends more on the random occurrence of events of nature, statutory requirements and interpretations thereof and the laws of probability rather than on the more predictable human actions that are primarily profit-oriented or economically motivated.

The safety valves appropriate to the insurance industry put much greater reliance than banks on prior assessment of the nature of the risks involved, appropriate pricing of the specific cover to be provided, scope for reviews, and the spreading of a prudent proportion of the risk by way of enforceable reinsurance spread over a number of reinsurance firms. Banks rely to a much greater extent on prior understandings and capacity to borrow temporarily or dispose of liquid assets. These differences between banking and general insurance suggest that in order to maximise confidence in the financial system it

would seem appropriate to continue to support specialisation in the supervision of the fundamentally different types of financial institutions.

The third main area of the financial sector that will continue to require specific supervisory arrangements is the capital markets, securities firms, portfolio management and other security and investment-related services. The distinguishing feature of this area is that the institutions are designed to allow their liabilities to vary automatically in line with changes in the market value of their assets, which can be volatile and unpredictable. While holders of securities cannot be protected from the effects of default by the issuers or ultimate borrowers behind such securities, supervision in this area should be concerned with the widespread availability of relevant information to facilitate continuous assessment of the prospects for the issuers of the securities.

Apart from the question of the exposure of the riskiness of the issuers of securities, supervision should also be concerned with the manner in which the cash, swaps, futures and options markets for purchasing and selling existing securities, and claims thereon, continue to be organised and managed so as to preserve the integrity of the exchanges and markets themselves. The continuous availability of information about the volumes and prices of securities traded together with the degree to which commissions and fees are competitively determined should also continue to be a concern to supervisors.

Furthermore, supervision of the securities industry should be concerned with the following in the case of firms that provide facilities for issuing, making markets, trading and managing portfolios of securities:

- ongoing capitalisation;
- professional fitness;
- liquidity and risk management ability;
- client protection and compensation arrangements; and
- conduct of business rules, that is, the standards to be applied in conducting business on behalf of customers especially non corporate customers.

Consideration also needs to be given to the question of updating standards and requirements in respect of the growing range of investment and financial advisory activities.

In the case of the evolving securities markets and related financial institutions, the appropriate safety valves to continue developing should include the extension and refinement of the following:

- the prudent practices of marking-to-market i.e. updating values by reference to the most up-to-date prices quoted;



- the calling of margins or deposits without delay as prices change adversely in order to underwrite ability to perform;
- the acceptance of the need for the ongoing commitment of the market makers in adverse circumstances to continue buying and selling securities despite unfavourable movements in their prices;
- the need to minimise the time lag between the date of the original purchase or sale of securities and the date of final settlement for them;
- the control and monitoring of the large risk exposures associated with the settlement of securities and other financial assets;
- the prompt provision of correct and timely information about volumes and prices of securities traded; and
- the promotion of closer co-operation between the organisations supporting and representing the different markets, exchanges and financial institutions.

The diversity of the securities and investment-related activities is such that it may not lend itself to as streamlined supervisory arrangements as in the case of banking and insurance. Indeed, as the banking industry has a special interest in securities-related activities, which will probably become much more important in the years ahead as bank assets themselves become more marketable, banking supervisors should be drawn further into the supervision of securities-related activities. The market-making activities of banks in the cash markets for securities as well as their involvement with both futures and options activities are important areas into which banking supervision should penetrate in evaluating the banks evolving overall risk-management policies and procedures. Close co-operation between the three main areas of supervisory responsibilities outlined above will be required in the decades ahead but especially in relation to the supervision of credit institutions, capital markets and securities-related activities.

The theoretical literature needs to be reworked if it is to be a more useful guide to policy makers concerned with the evolution of the financial sector in the decades ahead. The theoretical expositions accounting for the existence and contribution of banking institutions, non-bank credit institutions, assurance and insurance underwriting and the securities-industry should undergo fundamental presentational changes in the decade ahead and give an integrated picture of the role of the different activities within the financial sector. It would be useful also if this were accompanied by a reworking of the analytical foundations for the control and supervision, in the public interest, of the different types of financial activities - banking, non-bank credit institutions, securities and insurance - from both the monetary-policy and prudential-supervision perspectives. Furthermore, it would be useful to have the contribution of the evolving financial

institutions and markets to investment and the accumulation of capital in the economy evaluated. Moreover, the effectiveness of monetary policy as well as the efficiency of the means or techniques used to implement it must continue to be evaluated against the ultimate objectives of monetary policy. These are challenging areas for future theoretical and, indeed, applied research.

### **Integrating within Europe**

Before concluding it is appropriate to mention that the prospective developments outlined above will occur at the same time as financial and monetary integration is accelerating in Europe. One may ask, to what extent the prospective developments in the Irish financial sector will be affected by the creation of a single financial market throughout Europe and the pursuit of the longer-term goal of European monetary union. As a matter of interest, initiatives towards monetary and financial union were also a significant feature of Europe in the second half of the nineteenth century. They were associated with the unification of Germany and Italy and the emergence of a central bank in those countries and also with three wider regional experiences or groupings – a Latin monetary union (between France, Belgium, Switzerland, Italy, Greece and a number of other countries); a Scandinavian monetary union (between Denmark, Norway and Sweden) that was closely linked to London; and a German monetary union (embracing Germany and Austria). Adherence to the international gold standard in those days may have facilitated the establishment of monetary union independently of fiscal and economic integration in these regions.

In making further progress towards monetary union, in the years ahead European central banks will become more concerned with this objective and will be concentrating on the necessary conditions and means available for successfully defending prevailing exchange rates and minimising inflation. This will call for greater co-ordination of interventions in the markets to increase or reduce the supplies of individual European currencies in the context of agreed objectives between member countries for the growth in Community-wide holdings of money and bank lending.

Such interventions will need to be consistent with minimising or indeed avoiding exchange rate adjustment between European currencies and maximising the non-inflationary growth of the base of the European banking system. It is in these circumstances that the main benefits of a single European currency – lower foreign exchange transactions costs, more confidence in the stability of prices and lower interest rates at home and throughout Europe – will begin to accrue to the Irish economy. However in order to maximise these gains economic and monetary union must be viewed as a single process as agreed by the Delors Committee in its *Report on Economic and Monetary Union in the European Community* published in Spring 1989.

The process of European financial integration, will gain significant momentum in the 1990s with the implementation of the formidable legislative programme to

facilitate the completion of the single financial market throughout Europe. Firms in the Irish financial sector will find new opportunities to become more externally oriented, to forge appropriate co-operative relationships with financial institutions abroad and to compete for an increasing share of appropriate segments or areas of the more integrated European financial market. The successful establishment over time of a worthwhile presence in specific areas of the European market will require careful prior evaluation and, subsequently, a continuous significant management commitment. At the same time, the traditional home and export markets will need to be defended as new profitable markets abroad are penetrated.

Domestic and external growth objectives can be pursued simultaneously by earning and raising adequate capital to support the increased level and range of activities; by investment in appropriate technologies and management skills; and by the narrowing of margins, especially between interest received and paid, through greater efficiency in the use of human resources and more effective control of other non-interest costs. Over time, it is the low-cost producers of high quality products and services with a coherent strategic commitment that will continue to succeed in the struggle for increased market share in appropriate segments of the growing European-wide industry. Entry will become freer, exit more frequent, output prices lower and customers more demanding as the national financial markets in Europe become more integrated over the decade ahead.

Taxation policy, which takes account of the net effect of all tax measures and is even-handed in its approach to all domestic financial institutions, would also contribute to the efficiency and growth of the financial sector by ensuring that financial activity bears a similar level of taxation in Ireland as in the other member states. Full financial integration, without distortion of the location of financial services activity, cannot take place without fiscal harmonisation in respect of savings and investment activities and of the profits of the financial institutions themselves.

These developments referred to above will also be accompanied by the evolution of a European-wide system of mutually recognised supervisory arrangements. This is already well advanced in the case of credit institutions and insurance companies and rapid progress is being made in relation to a wide range of securities activities. It is envisaged that European-wide supervisory standards and arrangements will help to create and maintain a reasonably level playing field throughout Europe, thereby promoting greater competition between financial institutions and providing additional scope for locating the production of financial services where costs are relatively low. The supervision of financial conglomerates, whose activities embrace a wide range of diverse financial institutions in a number of European countries, will be a major challenge to the supervisory bodies throughout Europe.

It seems reasonable to conclude that what will be happening in Europe will primarily serve to accelerate some of the developments that would otherwise be

occurring in the Irish financial sector. But the changes in Ireland will be occurring in an atmosphere of a deeper appreciation of the need to minimise the centralising forces at work on the road to economic and monetary union in Europe. These have been portrayed by the evolution over the past fifty years of the financial sector in Northern Ireland compared with that of the Republic.

If there is to be successful adaptation in a more competitive climate to the significant structural changes that will occur in the financial sector in the decades ahead, it will be necessary to address the issues outlined above about the future course of the financial sector. It will be important to ensure that the benefits to society of the prospective changes in the financial sector are realised without exposing the financial institutions to inappropriate risk and society to monetary instability. The formulation and implementation of monetary policy and prudential supervision of the financial sector in a financial and monetary environment will continue to be a major and rewarding challenge to those involved in central banking, both at the national and European levels.

## FOOTNOTES

1. This coin was introduced in June 1990.
2. In respect of exports of goods and services, external borrowing and repatriation of foreign assets by residents (other than banks).
3. Arising from imports of goods and services, repayment of external capital and the acquisition of assets abroad by residents (other than banks).
4. Reduced to nine in 1989 due to the amalgamation of two societies late that year.
5. The Central Bank became responsible in September 1989 for the supervision of Building Societies and in February 1990 for supervising the Trustee Savings Banks.
6. The Central Bank reduced the primary ratio for all banks from 10 per cent to 8 per cent with effect from the 20 March 1991.

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## DISCUSSION

**N.J. Gibson:** I am delighted to have the opportunity to propose the vote of thanks to Dr. Padraig McGowan for his most interesting paper.

Dr. McGowan has chosen a wide canvas for his subject since in chronological time it covers almost exactly a millennium from the Norse settlement to the present day. The central purpose of the paper is to describe the major structural changes in the provision of currency, in the evolution of the banking system, including the development of central banking, and finally to look to possible future developments in the 1990s and beyond.

This is certainly an heroic undertaking within the compass of a single paper. As a consequence Dr. McGowan has had to be both selective in his choice of topics and in the space he could devote to their discussion and analysis. In that spirit I too propose to be similarly selective.

An interesting aspect of the evolution of banking in Ireland – and one which is highly relevant to the aspiration for monetary union in the European Community – is the role of the Bank of Ireland vis-a-vis the joint-stock banks and its relationship with the Bank of England. Dr. McGowan informs us that throughout the 18th century there was little enthusiasm in Ireland for the establishment of what was called “a national bank” or what we might describe as a central bank in embryo. However, towards the end of that century the exigencies of Government finances gave the necessary stimulus for the establishment of the Bank of Ireland with analogous responsibilities and privileges to those of the Bank of England. But as Dr. McGowan explains, various factors, not least the Act of Union, and the amalgamation of the two Exchequers strengthened the relative dominance of the Bank of England.

I think Dr. McGowan would probably agree that a fixed exchange rate between the former Irish pound and sterling, first of all in 1821 at a rate of thirteen Irish pounds to twelve pounds sterling and later in 1826 on a pound for pound basis was a more fundamental reason for the inability of the Bank of Ireland to emerge as a central bank. These developments, which might be described as a form of monetary union, coupled with freedom of movement of funds between Ireland and Great Britain, and granted the responsibility of the Bank of England for the maintenance of the sterling/gold exchange rate standard, would seem to have left no room for the Bank of Ireland to exercise the powers of a central bank.

It is, I think, recognised that monetary union on comparable lines within the European Community will necessarily have similar consequences. This is not to imply that monetary union should be opposed and it may be that it would bring overall net benefits but clearly there could also be adverse distribution effects on particular countries and, in addition, the determination of monetary and credit policy would be of critical importance to individual member states.

Neither the Bank of Ireland nor the Currency Commission nor the Central Bank of Ireland would appear to have had much influence on Bank of England policy during the period of monetary union from 1821 to 1979.

Another important and related theme running through Dr. McGowan's paper is the supervisory role of central banks and how this should operate under the influence of the Single European Market and in a period when traditional means of payment and credit transfer arrangements may be largely superseded or transformed by electronic transfer methods. The underlying basis for the supervisory role would appear to be the belief that financial institutions left to pursue their interests as they see them are likely to impose negative externalities of a serious order on the public at large. At the core of this position would seem to be at least two key considerations; the lack of information available to the public, or the right kind of information, about the detailed activities of financial institutions and the specification and enforcement of property rights. Might it be inferred from this that rather than tackle the supervisory question by elaborate regulations and back-up organisations financial institutions should be required to make publicly available regular and prompt access to carefully specified information about their activities and at the same time greater attention should be given to the legal definition and extension of property rights? In this way the market, operating within a legal framework, would itself undertake some or all of the supervisory functions.

Dr. McGowan, I think, would not accept this but goes out of his way to emphasise the "gaps in the theoretical literature" that need to be addressed if those concerned with the evolution of the financial sector are to have useful guidance and emphasises how important it is that there should be "a reworking of the analytical foundations for the ... regulation ... of the different types of financial activities ... from ... prudential-supervision perspectives". Few, I think, would disagree.

Dr. McGowan's paper touches on a host of other important issues, the problems posed for monetary and credit control at a time when rapid technological innovation is radically changing the spectrum of money and near-monies and the substitution possibilities between them. This indeed is a perennial problem and carries echoes of the famous Currency/Banking School controversy of the 19th century. But need we be all that concerned about it so long as substitution possibilities are less than perfect and unless the pace of technological change involves unanticipated large quantum leaps? Another is the economics of branch networks which is not unrelated to the foregoing – the pace of technological change. A further one is the contrasting developments in the provision of financial services in the Irish Republic and Northern Ireland, with it being much faster in the former. The differing outcomes would seem to owe much to the needs of Government finance in the Irish Republic – perhaps a mixed blessing – and the relative autonomy of the state enabling it to encourage the taking of initiatives by the banking system. These conditions were not

present in Northern Ireland and once more take us back to the complex issues surrounding the debate on monetary union.

I hope I have said sufficient about Dr. McGowan's paper to demonstrate its scope and its capacity to stimulate thinking about highly significant monetary matters.

It is with much pleasure that I propose the Vote of Thanks to Dr. McGowan for an informative and thought-provoking paper.

**K.P. O'Shaughnessy:** I congratulate Dr. McGowan on his excellent presentation. His paper covers a great wealth of information and there were many areas of possible interest. There are two issues of major importance to the Irish economy and people which were related to the evolving pattern of banking and bank regulation in Ireland. These were the devaluation of the Irish currency during the seventies when the linkage with Sterling caused Ireland to import inflation, the other was the growth of the National Debt which likewise commenced during the seventies (and the relationship between this and the control of credit which was originally narrowly focused on the Associated Banks). What lesson have and what action could be taken to avoid a recurrence of these developments?

Dr. McGowan made reference to the trends in market share between the various institutions in the deposit taking market. An aspect of this is the falling market share of cash in the hands of the public, which is in effect an interest free deposit with the Central Bank, and is in competition with the current accounts of the Associated Banks. It is interesting to note that this downward trend in the market share of cash was temporarily reversed when the banks introduced automatic teller machines. With interest now being paid on credit current accounts in Britain and with the introduction of EFT and wider plastic card access what is the likely future of cash?

**Reply by Dr. McGowan:** I am very pleased that Professor Gibson agreed to spare the time to propose the vote of thanks. He has been a major contributor to the debate about the changing Irish banking system, both in the Republic and Northern Ireland, since it evolved from what was virtually a dependent-type system in the 1950s to independence within the European Monetary System in the 1980s. I appreciate very much having the opportunity to have his valuable observations and comments on the paper. While a number of issues have been identified, I propose to respond to what I regard as the major theme raised this evening by Professor Gibson and which was also echoed in remarks by other speakers.

The fundamental issue raised by Professor Gibson concerns the role of a regional central bank in the context of monetary union. On reflection, one can recognise four significant interconnected influences that led to the emergence and development of central banking in the form we recognise it today in Europe. These are the need to promote an efficient system of payments within a country;

the need for lender-of-last-resort facilities to buttress the banking system; the need for a financial institution to promote order in the public finances and act as fiscal agent; and, finally, the need for an independent institution to formulate and implement monetary policy. In considering how these primary functions of a central bank may be executed in the context of monetary union in Europe, I suggest that in the 1990s we will be experiencing shifts of emphasises in the activity of a local or regional central bank rather than an absorption of its functions into a single European central bank.

While the prospects are that monetary policy will tend to be formulated at the overall EC level, this should be to the advantage of the Irish economy. It should eventually lead to a rate of inflation in neighbouring areas that would be consistent with the local objective for monetary policy. The local central bank would have an opportunity to contribute to the formulation of the overall thrust of European monetary policy and indeed to the manner in which it is to be implemented. Paradoxically, a central bank in a small open region of the European economy may have more influence in determining the outcome of monetary policy in its local area than if it remained isolated and continued to struggle with the difficulties of insulating itself from undesirable external inflationary developments. A system of fixed exchange rates in a relatively hard currency area should facilitate a regional central bank in being more successful in realising the objectives of monetary policy.

Similarly, the role of a central bank in respect of its influence on the public finances, may be enhanced in a monetary union. Fiscal financing may become local in orientation rather than national. Furthermore, it may have to accommodate itself fully to the conditions and terms of the European-wide capital markets in raising funds to finance deficits and in managing the outstanding public debt. While the rate of inflation and money market interest rates may be similar throughout a monetary union, the cost of capital to borrowers will vary depending on the credit rating of the borrowers, whether corporates or public authorities, and their abilities to service outstanding indebtedness in the future. Such a development could enhance the position of a central bank in relation to the implications of public sector financing especially if the policy being pursued by a local central bank were being supported by the overall stance of monetary policy in the European-wide monetary union. In responding to Mr. O'Shaughnessy, I would suggest that there may be greater protection from a recurrence of the fiscal imbalances and inflationary experiences of the 1970s and 1980s by participating fully in monetary union in Europe rather than remaining at one remove from it.

One of the most important functions of a central bank is to act as a lender of last resort when circumstances require such action. The range of credit institutions to which it may be regarded as appropriate to extend lender-of-last-resort facilities may widen over the decades ahead. This is because of the nature of banking and related activities and their inherent systemic risks. When one considers the manner in which the financial sector is evolving, it is probable that

even if monetary union were to become a reality, the operation of the lender-of-last-resort function will probably remain a local matter, especially for credit institutions with their head offices in the same country as the local central bank. The experiences in the United States since the 1920s, where the formulation and implementation of monetary policy has become centralised, suggest that the lender-of-last-resort function is more effectively conducted at the regional level, at one of the twelve regional Reserve Banks.

The growing importance of supervision in relation not only to banks but also to the rest of the financial sector is as much a concern with promoting competition by establishing a level playing field within the economy and between it and other economies as with the prudential supervision per se of credit and other financial institutions. Nevertheless, a dimension of prudential supervision that will grow in the future is the support and help it will provide to a local central bank to enable it to effectively implement its lender-of-last-resort responsibilities. Local knowledge of the strengths and weaknesses of a credit institution, especially that concerning the quality and marketability of its assets, its earnings capacity and the thoroughness of its prudential controls, may become an integral part of the extension of the lender-of-last-resort function. I agree with Professor Gibson that the timely publication of appropriate information by financial institutions about their risk exposures and level of capitalisation would help to contain the extent to which financial institutions might need to have recourse to a central bank.

Where I differ from him is that I would be reluctant to rely solely on published information and feel that supervision plays a useful role in highlighting excessive risks. Availability of information to the public may not be sufficient in itself to stem rapidly moving systemic problems or to highlight the quality of the non-marketable assets of a credit institution seeking lender-of-last-resort support. The reworking of the theoretical literature I suggested might help to identify where market failure is likely to occur in the financial sector; the importance of it; the roles that both the provision of information and prudential supervision might play in minimising it; and the extent to which it is appropriate to extend lender-of-last-resort support while at the same time avoiding excess moral hazard and distortions. It would also be helpful to explore these issues in the context of different degrees of competition within the financial sector.

Finally, central banks in many countries have been concerned over the decades with the implications of innovations in the methods for effecting payments for the efficiency and stability of their national payments systems. Competition between credit institutions may take care of a number of the concerns about technological developments referred to here this evening. Credit institutions will close branches that do not adequately reward the capital allocated to supporting them. Those branches or outlets that continue to operate will use the most efficient technology to deliver or provide financial services to their customers.

In responding to Mr. O'Shaughnessy's question about future trends in the use of currency I feel that it may play a smaller part in effecting payments, with current

account facilities and electronic transfer payments systems becoming more important.

As outlined in the paper, I envisage an increasing role for a central bank in setting standards for the efficient functioning of payments systems and for minimising the scope for breakdowns in settlement arrangements for cheques and other financial claims, including securities. While the responsibility for effectiveness of payments and settlement arrangements should rest with the providers of such services, nevertheless I envisage an enhanced role for a central bank at the national level despite the emergence of financial integration and monetary union in Europe.

Financial integration and monetary union may be quite demanding in their implications for the efficiency and stability of payments systems across frontiers and the European-wide prudential control of settlement risks arising in money and other financial markets. A local central bank may have to play a more prominent role than in the past if national arrangements are to be on a par with and compatible with those in all other member states. Otherwise the objectives of a single currency and financial integration would not become a reality in the market place. So I conclude by saying that many new challenges remain ahead for central bankers and that the activities of central banking will continue to evolve as has been happening for many decades, though at a faster pace. The evolution of federally-oriented central banking is what will be occurring in the next century.

Again, I wish to thank Professor Gibson for this thoughts and constructive comments. I also wish to express my appreciation to the other speakers for your observations and to all of you for your attention.