

Independence, Conservatism and Interest Rate Setting in Ireland¹

Ella Kavanagh, Department of Economics, UCC

1. Introduction

Theoretical and empirical studies on the relationship between Central Bank Independence/Conservatism and Price Inflation have been very influential in the design of monetary policy institutions. The initial theoretical developments (Barro and Gordon, 1983) illustrated that governments suffer from an “inflation bias”. Theoretical studies such as Rogoff (1985) highlighted how this inflation bias could be reduced, by delegating responsibility to a conservative and independent central bank. A conservative central bank is one who dislikes inflation more than the government. However this can have negative consequences for output fluctuations. In Lohmann (1992) a central bank can be “too independent”. A partially independent central bank i.e. one that can be overridden by the government, ensures that the central bank will respond to economic shocks without in fact the government ever having to actually interfere. In contrast to Rogoff (1985) and Lohmann (1992), Walsh (1995) considers the conservative nature of the central bank, not as a given but as an outcome of the incentives facing the central bank. This suggests that a conservative central bank can be guaranteed by providing the appropriate incentives.

The empirical literature has focused on measuring the degree of central bank independence/conservatism and relating this to a country’s inflation performance (Grilli, Masciandaro and Tabellini, 1991; Cukierman, 1992; Berger, Haan and Eijffinger, 2001). Generally these studies are cross sectional, using a large number of countries over a certain period of time. Studies such as these have faced a number of criticisms – in terms of the reliability of the indicators used as most of these measures are based on Central Bank Statutes and are open to interpretation (Mangano, 1998) and their relevance (Forder, 1996). The latter’s criticism is particularly significant - “A central bank may be independent by statute, and it is nevertheless accepted – on all sides - that the government will have its wishes implemented.. it is quite clear that the readings of statutes is not a measure of independence in the sense required by the theory.. There is no theory that says it matters what the rules say. *There is only the theory that says it matters what the behaviour is*” (43-44).

This paper examines the conservatism and particularly the independence of the Irish Central Bank. We examine using the measures in the literature, the degree of independence of the Irish Central Bank at its instigation. In line with Forder (1996), we also focus on the actual behaviour of the Central Bank over the 1950s and 1960s in order to evaluate its independence.

According to the literature (De Haan and Kooi (1997); Debelle and Fischer (1995), instrument independence, whereby the central bank has control over the money supply and monetary instruments, matters more for inflation performance. At the time of the establishment of the Central Bank, interest rates were set by the Associated Banks and were altered in line with changes in the British Bank Rate. For this instrument, there was total independence from the Government. We are assuming, in

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line with Posen (1995) that banks are conservative and do not like inflation or indeed in the Irish case, balance of payments deficits². Using the minutes of the Irish Bank Standing Committee over the 1950s and 1960s, we analyse the factors that were responsible for breaking this relationship (over the short to medium term) and how the Government (at different times) and the Central Bank increasingly over time began to exert much greater control on the interest rate setting behaviour of banks. We also note how government “threats” were invoked, at different times, to get the banks to behave more in line with the wishes of the government and why the government was willing to incur the cost of interference in banking activities, in order to achieve their objectives.

This study is similar to historically based studies e.g. Berger and De Haan (1999) by providing an historical account of interest rate setting in Ireland. This paper adds to earlier work on the Irish Central Bank (Moynihan, 1975) by using some of the evidence therein, to analyse the degree of independence of the Irish Central Bank and its level of conservatism³. We also extend the work of Moynihan (1975) and Honahan & O’Grada (1998) by examining the interest rate setting behaviour of banks in the 1950s and 1960s. Finally this study illustrates that a central bank’s independence from the government is significant for inflation and balance of payments performance for countries that have fixed exchange rates (Walsh, 1997).

Section 2 examines the political and economic independence of the Irish Central Bank. As a background to Sections 5 and 6, Section 3 examines the interest rate setting behaviour of banks in the 1920s, 1930s and 1940s. Sections 5 and 6 examine interest rates setting by the banks in the 1950s and 1960s. Section 6 concludes with suggestions for future work.

2. Political & Economic Independence of the Irish Central Bank

2.1 Central Bank Act, 1942

In this section, we use measures of Central Bank Independence, as discussed in the literature (Grilli, Masciandaro and Tabellini (1992), Cukierman (1992) and Mangano (1998) to classify the level of independence of the Irish Central Bank at its instigation and during the period under review.

We begin with the Grilli, Masciandaro and Tabellini (1992) measure (henceforth known as GMT), which separates the overall independence measure into two components: **Political Independence** and **Economic Independence**. The former refers to the capacity of the monetary authorities to choose their own final goals of policy. The latter refers to the autonomy of the central bank in choosing the instruments of monetary policy.

Tables 1 and 2 in the Appendix classify the degree of Political and Economic Independence of the Irish Central Bank at its instigation, using GMT’s criteria, based on the legal statues of the Central Bank. The Irish Central Bank satisfies 2 of the independence criteria. The Governor’s statutory term was for a period greater than 5 years. Secondly price stability was one of its statutory goals in that the statutory

² This is reasonable given that balance of payments deficits negatively affect a bank’s external assets and in turn their ability to lend.

³ In the absence of access to Central Bank Files.

responsibility of the central bank was “to safeguard the integrity of the currency and ensuring in what pertains to the control of credit, the constant and predominant aim shall be the welfare of the people as a whole”. In relation to government approval of monetary policy, there is nothing in the statutes to suggest that government approval was required except that “The Minister may on such occasions as he shall think proper, request the Governor to consult and advice with him in regard to the execution and performance by the Bank of the general function and duty imposed on the Bank”. Excluding this factor, the Irish Central Bank only satisfies 2 of the 8 criteria specified, meaning that the Irish Central Bank was not *politically independent*, at its instigation.

Cukierman (1992) also provides a measure of Central Bank independence. His scoring for the Irish Central Bank in the 1950s and 1960s is given in the Appendix. 1950s. His measure is based solely on the Central Bank statutes and not on their performance. “It suggests what is the degree of independence that legislators *meant to confer* on the Central Bank” (Cukierman, 1992). According to his classification the Irish Central Bank emerges as independent on certain criteria – the appointment, term of office and dismissal of the governor and the objective of monetary policy. He considers that there is insufficient information in the statutes to determine who formulates monetary policy and Government Directives and Conflict Resolution. Mangano (1998) compares the 2 different measures and identifies independence criteria that are similar to both. Under the *political independence* criteria, the following are common: (i) who appoints the Central Bank governor, (ii) the term of office of the Governor, (iii) who formulates monetary policy, (iv) price stability as a statutory objective and (v) legal directives for conflict resolution. Out of a possible score of 5, the Irish Central Bank obtains 3 (Mangano, 1998), lower than the Bundesbank score of 5 but similar to Switzerland.

The Irish Central Bank (1942), based on its legal statutes, had some level of *instrument independence*, the second criteria used by GT&M. According to O’Mahony (1962: 85), the Central Bank Act (1942) did not authorise the Central Bank to make loans to the Government. Therefore there was no automatic credit facility. However in relation to holding securities, the Central Bank could “Buy, hold or sell securities of or guaranteed by the State which have been offered for public subscription or tender before being bought by the Bank”. Hence they could operate in the primary market for public debt.

GT&M (1992) focus on the discount rate as the monetary instrument. Where the central bank does not have control of this rate, its ability to determine the general level of interest rates is severely impaired. The Irish Central Bank did not set a discount rate, as in other Central banks, which formed the base for interest rates in the rest of the economy. Instead the Associated Banks set their retail lending rates in response to changes in the British Bank Rate, and without government interference, at the time of the establishment of the Irish Central Bank. Hence this monetary policy instrument was under the control of a separate body, the Associated Banks. Taking the measures of instrument independence, common to both (Central Bank lending to Government at market rates, loans from the Central Bank to the Government must be temporary, there is a limit on lending by the Government to the Central Bank and whether the Central Bank can purchase Government debt in the primary market), the Irish Central Bank appears to have *instrument independence* when it was established.

2.2 The Practice of Independence

Forder (1996) argues that “A central bank may be independent by statute, and it is nevertheless accepted – on all sides - that the government will have its wishes implemented.. it is quite clear that the readings of statutes is not a measure of independence in the sense required by the theory.. There is no theory that says it matters what the rules say. There is only the theory that says it matters what the behaviour is” (43-44). Laws may not be able to explicitly specify the limits of authority between the central bank and the political authorities. And even when they do, Governments may not invoke the powers that they have been given (Berger, De Haan and Eijffinger, 2001). On this basis, in terms of practice, how independent was the Irish Central Bank?

Firstly, how politically independent were they? We argued earlier that the Irish Central Bank, using a common measure (Mangano, 1998), was relatively politically independent. In terms of the rate of turnover of the Governors (Cukierman, 1992), it also emerges as very independent. All governors were re-appointed after their initial term hence the average turnover was in excess of 8 years⁴.

Were they Conservative? Three of the 8 members of the Board were from the banks. This had been criticised during the Dáil discussions on the Central Bank Act 1942 (Dáil Debates, 23rd April, 1942) as the banks were considered to be highly conservative in their practices⁵. Similarly all the Governors had originally been in the Department of Finance, which was also highly conservative (Fanning, 1978; Lee, 1989).

Did they have instrument independence? The Government at different times during the 1950s and 1960s attempted to get the Central Bank to exercise some of the powers given to it in the Central Bank Statutes, with some success. One of these powers was the ability to be able to rediscount bills of exchange and Exchequer Bills which had previously been accepted, discounted or endorsed by an Associated Banks and to fix the minimum rate on the re-discount rate.

In 1945, the then Minister for Finance, Mr. Frank Aiken⁶, wanted “to make capital more cheaply and readily available for public purposes” (Moynihan, 1975:326). Moynihan provides an outline of the events and discussions between the Minister and the Governor, Mr. Brennan. It would appear that in order to deflect the Minister away from adding domestic assets to the Legal Tender Note Fund, the Governor was willing to “confer with him on a separate suggestion regarding possible facilities for rediscount of Exchequer Bills” (1975:327). The Government wished to issue Exchequer Bills to the value of £10m and it was proposed that the Central Bank might be asked to rediscount 5% of such bills.

⁴ Mr. Brennan, the first Governor, was criticised heavily in the wake of the 1951 Central Bank Report and despite being reinstated for a second term in 1950, resigned in 1953. He had informed the Minister for Finance that he did not wish to be reappointed in mid January 1950 (Moynihan, 1975:370).

⁵ The contribution of the banks to the conservative Commission of Inquiry into Banking, Currency and Credit Report (1938) would suggest this.

⁶ Of Fianna Fail.

Three issues emerge as being significant in the Central Bank's deliberations: (i) their concern about the impact that this would have on inflation (in keeping with their conservative stance); (ii) their view of their role as providers of liquidity to the banking system, in the absence of a secondary market for Irish Government Bills, as otherwise the banks would be left with "frozen assets" and (iii) their desire to retain autonomy and independence in the setting of the rediscount rate. The latter became a point of issue. An initial proposal of the Minister was that the Central Bank would re-discount 5% of the total value of bills issued (£10m) to the Associated Banks, at the rediscount rate equivalent to the discount rate at the time of issue. This was viewed by one member of the Board as in effect "direct lending by the Central Bank to the Government" (Moynihan, 1975:329). The Central Bank retained some autonomy in setting the re-discount rate in that it was set at one sixteenth of 1% above the highest rate at which any Exchequer bills outstanding had been discounted (Moynihan, 1975:330). However it was less than their preferential rate which was the published minimum rediscount rate of 2½%⁷." (Moynihan, 1975:330). No actual re-discounting of Exchequer Bills took place on this occasion.

This re-emerged in December 1955 when the associated banks informed the Inter-Party government of that time that they would be unable to sanction the additional £5m requested by them, because of their external reserve position (IBSC Minutes, 19th December, 1955). A solution was found once the CB undertook to rediscount £2.5m of Exchequer Bills immediately and a further £1m later. Through its lender of last resort function, the Central Bank became indirectly a provider of finance to the government. This facility appears to have been relatively automatic. It was temporary (Exchequer Bills had to mature in not more than 12 months) and was for a limited amount. Over time, this re-discount rate became more market based⁸. According to the GM&T criteria for instrument independence, this rediscounting function would imply a high level of instrument independence for the Central Bank.

According to the Central Bank statutes, the Central Bank could "Buy, hold or sell securities of or guaranteed by the State which have been offered for public subscription or tender before being bought by the Bank". This provision was criticised by the Associated Banks at the time of the Central Bank Act, who argued that, "the power to buy newly-issued Government securities would lend itself to abuse" (Moynihan, 1975:307). Practice suggests some difference from the statute. In 1965, "as an exceptional measure", the Minister for Finance issued a loan, which was sold to the banks and immediately acquired by the Central Bank (Central Bank annual Report 1965/66:45). The loan had in fact been created for this purpose. The reason why the banks were unable to acquire the loan was because it would breach their credit guidelines with the Central Bank. This appears to have been the first time that this was invoked, suggesting again a difference between what the government could do and what was actually done.

In other ways, the Central Bank has exercised a high degree of independence from the government in terms of their ability to comment and criticise government policy,

⁷ No actual rediscounting of Exchequer Bills took place under the arrangement of April 1946 – or at all until January 1956.

⁸ From Nov 1960, the rediscount rate was determined from month to month by adding one sixteenth per cent to the highest rate accepted at the preceding public tender for Exchequer Bills and rounding down the result to the nearest one–sixteenth (Moynihan, 1975:454).

which they have done during the 1950s (we noted earlier the 1951 Report which caused such controversy) and the 1960s.

The evidence above, suggests that despite the conservatism of Central Bank Governors, the Government was able to exercise, whatever powers it had been granted. Being highly conservative matters little if the Central Bank has little instrument independence and can be over-ridden by the government.

3. Interest Rate Setting –1920s, 1930s and 1940s

3.1. Lending and Deposit Rates

In order to understand the changes that occurred in interest rate setting over the period under review, we will analyse how interest rates were set prior to the establishment of the Central Bank and the independence that the banks enjoyed in setting interest rates.

On March 16th, 1920, it was agreed that a “Standing Committee of the Banks should be formed and meet quarterly or oftener if necessary to fix rates for Overdrafts, Loans and Discounts for all banks and that a copy of such rates should be exhibited in all the office of the banks and strictly adhered to without exception” (IBSC Minutes, March 16th, 1920). The rate to be announced by the Banks and published in the Press would be known as the *Irish Banks’ Rate* instead of, the Bank of Ireland rate.

A schedule illustrating how various bank interest rates would change in response to a change in the Bank Rate (Bank of England Rate) was developed during the early part of the 1920s and a synopsis of this schedule is available in the Irish Banks Standing Committee Minutes, 1925. A modified and extended schedule operated from January 1935.

The Second Banking Commission Report explains the nature of the relationship that existed between Irish and UK interest rates.

“Any attempt to pay a rate of interest upon deposits lower than that ruling in Great Britain or in Northern Ireland would divert some savings deposits to these areas; any attempt to pay a rate of interest upon deposits lower than that ruling in Great Britain or in Northern Ireland would divert some savings deposits to these areas; any attempts to charge rates of interest substantially higher than those ruling upon various categories of advances in those areas would also mean a transfer of business (Commission of Inquiry into Banking, Currency and Credit, 1938: 194).

“Experience has taught Irish bankers to expect certain consequences from movements in the Bank of England’s Rate (Bank Rate), consequences which react upon the relative competitive position of the British and Irish Banking systems. The maintenance of equilibrium conditions requires Irish rates to be at certain level relatively to British, whatever the position of the latter may happen to be” (Commission of Inquiry into Banking, Currency and Credit, 1938:198).

In relation to Deposit Accounts, the Banks competed with the English Banks, particularly for Deposits of greater than £2,000. For small deposits (Deposit Rate on Ordinary Accounts and amounts less than £2,000) a schedule of rates applied. For larger deposits (£2,000 and above) the deposit rates were directly linked to the

London's Banks' Deposit Rate⁹ e.g. for amounts between £2,000 and £25,000, the London's Banks' Deposit rate applied when the Bank Rate exceeded 3½%; for deposits of £25,000 the deposit rate was ½% point over the London's Banks' Deposit Rate and for amounts of £50,000 and over, it was either 1% or ½% over the London's Banks' Deposit Rate¹⁰. These rates applied through the 1920s, the 1930s and the 1940s.

A similar schedule applied for Lending Rates. Again the Commission of Inquiry into Banking, Currency and Credit provides a justification for the lending rates set by the Irish Banks. "Taking historical experience into account, the Irish Banks' rate moves at 1% above Bank of England rate when the latter is below 5 ½% and at one-half of 1% above Bank Rate when that rate is at 5 ½% and over. The tendency for Irish Banks' rate to fall less fast than Bank Rate for low levels of this rate, and to rise less fast as this rate moves up, finds its analogy in the fact that British loan and overdraft rates do not follow Bank Rate continuously, whether in an upward or downward direction (Commission of Inquiry into Banking, Currency and Credit, 1938:198).

In general the Irish Banks changed their interest rates on the same day as the change in the British Bank Rate¹¹. The only exception was the increase in the Bank Rate to 6% when Britain left the Gold Standard on the 21st September 1931. The Irish Banks did not change their rates until the 29th September 1931. Banking representatives had been summoned to the Currency Commission to discuss the implications. In their report back to the IBSC, "the banking representatives wished to suggest to the Standing Committee that the Banks should endeavour to show the people of this country that they were not inextricably bound up with the Bank of England and in every emergency that might arise in Great Britain and Foreign Countries, and they felt that the most satisfactory way of achieving this object and to allay feelings of nervousness would be to make no change in the present rates as a temporary measure only" (IBSC Minutes, 21st September, 1931)¹². Representatives of the banks in the North were not present at the meeting and did not share this view. Interest rates were subsequently raised – "Since the Committee's decision to make no alteration in the rates had been reached a sufficient time had elapsed to enable confidence to be restored and in view of the discontent which prevailed amongst depositors, a revision of the rates was imperative" (IBSC Minutes, 28th September, 1931). The Banks decided not to repeat the experiment and "to continue the practice of adhering to the schedule in any further change which may take place in the Bank of England rate" (IBSC Minutes, 28th September, 1931).

⁹ Although for low levels of the (English) Bank Rate, interest rates on small amounts were identical to the London's Banks' Deposit Rate.

¹⁰ 1% above the London's Banks' Rate was paid when the Bank Rate was 5% or less and ½% above, when the Bank Rate was greater than 5%.

¹¹ There was no change in the British Bank Rate over the period 1933-1938 and between 1940 and 1950.

¹² The banks from the North were not present at the meeting and were unhappy with the decision taken. In fact the cartel broke down in that the Belfast Bank quoted rates based on the new Bank Rate. It emerged that the decision on interest rates was not only an attempt to illustrate independence but was based on information that the Midland Bank had entered into an agreement with the other clearing banks not to increase their "country" deposit rates on ordinary accounts and not "to take knowingly any such deposits from other banks at higher rates". It emerged that no such decision had been made. Consequently the banks found it necessary to re-visit their earlier decision.

3.2 Margins

The relationship between Irish and British interest rates was not discussed in the Final Majority Report of the First Banking Commission (1927)¹³ although it did appear in the Minority Report, of J.J. McElligott, Secretary to the Department of Finance and a member of the Commission. He questioned the actual rates charged by Irish banks and the reasons for the larger margin between deposit rates and lending rates in Ireland in comparison to England (owing to lower rates being paid on deposits). “I trust sufficient has been said to indicate that there is a problem” (Banking Commission, Minority Report, 1927: 63)¹⁴.

The Second Banking Commission did compare the “spread” between Irish lending rates and the Bank Rate with the “spread” in British banks. They concluded that “comparisons, as far as the circumstances permit, with the normal British position and with rates charged and allowed by the Clearing Banks, shows that the spread in Ireland is not substantially greater than in Great Britain” (Commission of Inquiry into Banking, Currency and Credit, 1938: 198). In relation to comparing the margins between lending rates and deposit rates of Irish Banks with those in Britain, their focus was on the differences between banking practices in both countries and the implications for comparison. “Thus while the banking system, has on the one hand, a higher ratio in the Free State of interest earning deposits to total deposits, it operates with a low ratio of commercial assets to aggregate deposits. These facts, in themselves, would not justify relatively high loan charges, but they throw light upon the difficulty of assessing the situation merely in terms of the “spread” between interest charges and deposit rates” (Commission of Inquiry into Banking, Currency and Credit 1938:200).

Table 4, in the appendix compares the lending rates, given in the initial schedule of 1925 with that of 1935. As deposit rates were left unchanged, the margin between lending rates and deposit rates was increased¹⁵.

4. Interest Rate Setting –1950s

At the beginning of the 1950s, the Irish banks made 3 changes in the way that they set interest rates. (i) They abolished the Bank Rate as in their view “it was no longer significant nor had it any special relationship to the other rates in the table” and they wanted greater flexibility in the rate structure so that one rate could be changed without all others” (IBSC Minutes, 22nd February, 1952). (ii) They organised a new table of lending rates. (iii) More significantly, they made the decision that “no changes in the Irish Bank Rate structure will in future operate automatically on a change in the Bank of England rate” (IBSC Minutes, 18th February 1952).

During the 1950s, the independence that the banking sector had previously enjoyed in setting interest rates began to be eroded. Why was this? An examination of the

¹³ Except to state in connection with loan rates that “the rates nominally charged by the banks, and running up on various classes of paper to 6½%, are not higher than those which prevail elsewhere for similar classes of loans” (Final Majority Report of the Banking Commission, 1927:43).

¹⁴ As stated earlier, the schedule was altered in the 1930s. What is significant is that, rates were increased for all loans, with the exception of the rate on Irish Trade Bills and the category “All other Bills and Overdrafts” as the rates, including the Irish Banks Rate, applying to different loan categories was changed. Given that deposit rates remained unchanged, margins were effectively increased.

¹⁵ How much of this was due to an increase in the level of risk is unclear.

interest rate decisions made by the banks during this period, provide us with some possible explanations. A number of other players, the Governor of the Central Bank and the Minister for Finance, began to influence the way that interest rates were set while other factors, besides purely banking considerations, entered into the interest rate decisions.

4.1 The Beginning of Change: 1952/1953

On 12th March 1952, the British Bank Rate was increased from 2½% to 4%, which was followed by an increase in the London Banks' deposit rate from ¾% to 2%. The Bank Standing Committee met on the following day, the 13th March to discuss the interest rate change.

The Chairman of the IBSC had discussed the situation with the Governor of the Central Bank, prior to the meeting. The view of the banks was that deposit rates would have to be increased to 2% because of their fear that any disparity between deposit rates in Ireland and London would result in an outflow of funds/deposits. Consequently the overdraft rate would have to be increased by at least 1½% to 6½% "with possibly higher increases in the lower rates". The need to increase lending rates by more was because the banks were unsure about how much deposits would increase and loan demand would fall in response to higher rates of interest.

Both the Minister for Finance, Mr. Mc Entee¹⁶ and the Governor of the Central Bank were advised of their decision in advance of its implementation. The Governor also conferred with the Minister for Finance (Moynihan, 1975:394).

The decision of the Banks to increase interest rates, was consistent with the advice of the Central Bank in its 1951 Annual Report. The latter had expressed concern about inflationary pressures, the significant rise in the balance of payments deficit in 1950 and the decline in the external assets of the Associated Banks. In their view "measures directed to the restoration of stability have become an urgent necessity" (Central Bank Annual Report, 1951:9). While most of their discussion was on the need for fiscal correction, "rigorous restriction of bank credit for non-essential and less urgent purposes" was also considered to be imperative (Central Bank Annual Report, 1951:16). In their 1952 Annual Report, the Central Bank acknowledged the role of higher interest rates (along with various fiscal measures introduced in the 1952 Budget) in reducing the volume of imports and improving the balance of trade.

The Government requested a meeting with the IBSC at Government Buildings (on 18th March). They wanted the banks "to defer the increase in interest rates"¹⁷. The Taniste, Mr. Lemass pointed to the high profits of the banks and the high cost of branches as an argument for why the banks should maintain the overdraft rate while at the same time increasing the deposit rate. At that time, the Minister for Finance was planning to introduce a contractionary budget, in response to the deterioration of the

¹⁶ Of a Minority Fianna Fail Government, in June 1951.

¹⁷ A meeting was held in Government Buildings, on 18th March, which was attended by representatives of the Irish Banks Standing Committee, the Taoiseach, Eamon DeValera, Minister for Finance, Sean MacEntee and the Taniste, Sean Lemass.

balance of payments in 1951 (Fanning, 1978:483)¹⁸. The conservative stance of the Central Bank was shared by the Minister and the Department of Finance.

Table 1: March 12th, 1952: Bank Rate increased to 4%

	Banks' Decision	Government	Outcome
Deposit Rate	2%		<£25,000 – 1½%
			>£25,000 – 2%
Overdraft Rate	6½%	No Change (Defer)	6%

The Government did not get the banks to defer the increase in the overdraft rate but the deposit rates were modified so as to allow for a smaller increase on the overdraft rate. The new rates were introduced on 20th March, 1952¹⁹. The desired margin of 4½%, was maintained on deposit accounts of <£25,000.

The banks protected their cross border outflows by requesting (on the 24th March) and obtaining an agreement from the British Banker's Association that the latter would not pay more than 1½% on any new deposits < £25,000 transferred to them by residents in Ireland²⁰. A similar request had been made by the British Bankers Association to the Irish Banks Standing Committee in 1945 and agreed to by the Irish Banks.

September 1953

On 17th September, the British Bank rate was reduced by ½% from 4% to 3½%. The London Banks Deposit rate was reduced by ¼% to 1¾%.

The new Governor of the Central Bank (JJ. McElligott) had already conveyed to the Banks a request by the Minister that no decision should be announced before the Government had been given an opportunity of considering it (Moynihan, 1975:415). On the 21st September the Minister told the Governor that he wished to have an informal discussion on the question of the effect of this change on the deposit and lending rates of the Irish Banks (Moynihan, 1975:415). Mc Elligott supported the banks in his discussion with the Minister – He pointed out that the banks had not increased their interest rates in line with the British Bank Rate in March 1952 (Moynihan, 1975:415).

The Banks must have been aware of these discussions. At their meeting on the 22nd September, the decision of the banks was to change the deposit rate on amounts of >£25,000 to the new London Banks Deposit Rate with the deposit rate on amounts of <£25,000 reduced to 1¼%, ½% below. As stated in IBSC Minutes, for large amounts the Irish banks were in competition with the British banks whereas for smaller amounts their competitors were the Post Office Savings Bank and the Trustee Savings

¹⁸ Interestingly in the debate in the Dail on the Central Bank Report 1951, the Taniste Sean Lemass, made it clear that the solution that the Government intended to follow was “diametrically opposite to that which the Central Bank suggests”. The Government’s solution was not to cut down consumption but to increase production. They expected the co-operation of the Central Bank and the commercial banks, and if necessary they were prepared to take steps to ensure that they would get that co-operation (Moynihan, 1975:383).

¹⁹ In the Budget, 1952, the Minister for Finance acknowledged the difficulties that an increase in interest rates would entail, but argued that it would also promote savings.

²⁰ The agreement was from the London Clearing Banks. “The decision was conveyed to all the “Authorised Banks” with the request that they would conform with the new arrangement”.

Banks. To maintain the margin between the deposit rates and the overdraft rate, it was decided to reduce the overdraft rate and all other rates by ¼% only (which changed the relationship between the bank rate and the overdraft rate).

However for one category a different change was suggested. In order to “make the proposal attractive to government” it was agreed that a ½% reduction should be applied to loans in Categories E2, E3 and E4, those applying to government related loans.

Both the Minister for Finance and the Governor of the Central Bank were advised of their decision in advance of its implementation.

Table 2: September 17th, 1952: Bank Rate reduced to 3.5%

	Banks' Decision	Government	Outcome
Deposit Rate	<£25,000 – 1 ¼%		Original decision applies
	> £25,000 – 1 ¾%		
Overdraft Rate	5¾%	5% rate on Loans for Productive Purposes	Original decision applies
Collateral Loans	C1 – 4 ¾%		
	C2 – 5 ¼%		

On September 25th, the IBSC had a meeting with the Acting Minister for Finance, Mr. Aiken. He wanted more flexibility and experimentation in the way that interest rates were set. Specifically he wanted the banks to reduce the rate charged on loans for productive purposes to 5% and to reduce their deposit rates by more than originally specified to accommodate this. If this led to “reduced deposits, then they could reverse their decision” later. The counter arguments put forward by the banks were: (i) the danger of losing deposits if Irish rates were below British rates²¹; (ii) the reduction in rates would not increase profits (as it was, profits were negatively affected by the reduction in call money rates); and (iii) the need to improve their reserves which had been greatly affected by the fall in the value of securities.

Despite this request, the banks held to their original decision and the new rates were introduced from the close of business on 30th September 1953. Again as before an agreement was made with the British Bankers Association in relation to deposit rates.

May 1954

The Independents withdrew their support from the Government in May 1954. On the 13th May, 1954, the Bank Rate was reduced to 3%. The banks proposed to reduce their rates, in line with their previous changes – ¼% decline for a ½% fall in the British Bank Rate. The exception was the deposit rate on amounts of >£25,000 which was reduced in line with the ½% fall in the London Banks' Deposit Rate effectively widening the margin between the overdraft rate and this deposit rate. As noted by Moynihan (1975:416), the Government was not satisfied. The Governor of the Central Bank attended the meeting with the IBSC and Mr. Whitaker from the Department of Finance. The initial decision of the Banks on advances and deposits was not changed but interest rates on categories E3 and E4 (government borrowing) were reduced by a further ¼%. On the 2nd June, a new inter-party government was in place.

²¹ In the banks' opinion, they were very vulnerable as many of the larger depositors maintained bank accounts in England.

4.2 Threats to the Banks' Independence and their Response: 1955/1956 Jan and Feb 1955

On January 31st, the British Banks rate was increased by ½% to 3½% and on the 24th of February to 4½%. The decision by the banks, after the January increase, was to raise the deposit rate on amounts of >£25,000 to 1½% following the increase in the London Banks rate from 1¼% to 1½% but to leave the deposit rate on amounts <£25,000 unchanged at 1%. No reasons are given in the Minutes explaining these decisions²². This was consistent with their earlier views on the relevant competitors for different deposits.

There was a notable shift in overall government involvement in interest rate decisions in the case of the February increase in 1955. The Minister for Finance, Mr. Sweetman made his views known to the Chairman of the Irish Banks Standing Committee in advance of the meeting. The Minister argued that the increase in interest rates in Britain was a temporary one and was a response to inflationary conditions there but was inappropriate for Ireland's economy.

From the banking perspective, the banks argued that interest rates on deposits >£25,000 would have to be increased in line with the increases in the London Banks deposit rate, to prevent an outflow of funds. In the interests of "equity" and also because of competition, which the banks would experience from the Post Office Savings Bank and the Trustee Savings Bank, (particularly for the Nt. Ireland banks), the lower deposit interest rate would also have to be increased. The gap between the two deposit rates would now be 1% (an increase from ½%). Lending rates would correspondingly have to be increased.

Table 3: February 24th, 1955: Bank Rate increased to 4.5%

	Banks' Decision	Government	Outcome
Deposit Rate	<£25,000 – 1 ½%		No change
	> £25,000 – 2 ½%		> £25,000 – 2 ½%
Overdraft Rate	6 ¼%	No increase in Interest rates	No change
Collateral Loans	C1 – 5 ¼%		
	C2 – 5 ¾%		

In their meeting the banks did express concern that if interest rates were to be determined without reference to the British Bank rate, then they would "find themselves on the occasion of future issue of Exchequer Bills confronted with a proposal that the bills should be discounted at some artificial rate which would be out of line with actual market conditions", hence affecting the independence of the Central Bank.

The Minister was informed of the decision. The response of the Minister was to inform the Chairman of the IBSC that "should the bank's intimated intentions, be adhered to, he would be tempted to ask the public to give him special powers to prohibit them from making any increase in their lending rates, or alternatively use the powers available to him which the banks on another occasion had asked him to operate" (IBSC Minutes, 2nd March 1955). This would have taken away the banks'

²² The rate on Fine Trade Bills domiciled in London was also increased to 1%.

autonomy in setting interest rates with, what they saw, as negative consequences for the public's confidence in the banking system. It was not perceived as an idle threat and the Chairman was convinced that the Minister "would not hesitate to act to implement his statement, should the necessity for doing so arise" (IBSC Minutes, 2nd March, 1955). The banks adhered to the Minister's request on lending rates but did increase the deposit rate on deposits >£25,000 to 2½%²³. The arrangement with the British Bankers was invoked to protect deposits of <£25,000.

The Central Bank Governor, Mr. Mc Elligott was in agreement with the banks that interest rates should be increased. In August, the Minister had agreed to an increase of ½% to 4% on government guaranteed advances, after discussions with the Governor. The Central Bank Annual Report 1955, also referred to the close connection that existed between Irish and British interest rates but focussed on the implication of differences in deposit rates on the banks' ability to obtain deposits, thus affecting their capacity to provide loans and advances (Central Bank annual Report, 1955:31).

In August the feeling was that the group of banks should make representations to the Minister on their own behalf rather than leaving it to the Central Bank²⁴. However at the IBSC meeting in September the question was being raised whether "it would be more politic for the banks to make their representations through the medium of the Governor of the Central Bank, rather than directly to the Minister" in the light of the figures in the Central Bank aggregate monthly returns. The outcome was that the Central Bank would be consulted for their views on their submission to the Minister but the actual meetings would take place between the Minister and the IBSC.

In their submission, the banks focussed on the monetary and banking implications of the failure to increase interest rates – the reduction in deposits, the increase in advances, the large deficit in the balance of payments and the sharp decline in the net external assets of the banks. The view of the banks was that "this was a danger to the Banking System, to the currency and to the country as a whole". This has been well documented by Honohan and O'Grada (1998) and need not be examined here.

What is interesting is the discussion between the Minister for Finance and the Banks regarding the appropriate increase in rates and the way in which the interest rate increase was to be announced. The Minister submitted two proposals to the banks for their consideration:

Table 4: Ministers Proposals of 14th November, 1955

	Proposal 1	Proposal 2	Outcome
Deposit Rate	¾% Increase	½% Increase	½% Increase
Overdraft Rate	1% Increase	¾% Increase	¾% Increase

²³ The Northern Banks decided to operate their own interest rate schedule. The ordinary deposit rate (<£25,000) was increased to 1½% while the rate on deposits of >£25,000 was increased to 2½%. The Overdraft rate was increased to 6½%.

²⁴ In August 1955, it was felt by the banks that "the situation had not developed to such an adverse extent as to render it possible for the banks, to produce submissions, which would counter the points of view held by the Minister, as conveyed to the banks in the course of several interviews held at government buildings".

The Minister's preference was for Proposal 1, which had been agreed to by the Governor of the Central Bank. The Bank's preference was for Proposal 2, because "they would experience a serious loss of earnings by reason of the greater proportion of their deposits in the under £25,000 class". The Minister had also stated that he intended to announce the change in rates. This was an important feature of bank autonomy "An intimation of alteration in the rate schedule was considered to be the prerogative of the Banks and one over which the Minister had no-effective jurisdiction". The Minister, after discussions with the Central Bank agreed to their proposal and interest rates were allowed to be increased²⁵. This reduced the margin between the overdraft rate and the deposit rate on larger deposits >£25,000 from 4% points in the early 1950s to 3.75% points. On the other hand the margin between the overdraft rate and the deposit rate on deposits of <£25,000 was increased from 4.5% to 4.75% points.

February 1956

A similar situation arose in 1956. The British Bank rate was again increased in February 1956 from 4½% to 5½% with the London Banks deposit rate rising to 3½%. To maintain a similar deposit rate with the London rate, required a corresponding increase in the deposit rate for amounts >£25,000 to 3½% (2½% for <£25,000). The Banks favoured increasing overdraft rates to 7½%. In the early months of 1956, the banks had continued to experience a fall in deposits, an increase in advances and a reduction in external assets (IBSC Minutes, 13th April, 1956).

The Governor of the Central Bank took a more active role in the discussion between the banks and the government. He informed the IBSC that the proposed rates would be unacceptable to the government and proposed an alternative, more in line with "our own internal economy"²⁶ whereby deposit rates for amounts <£25,000 and greater than £25,000 would be increased to 2¼% and 3½% respectively and the overdraft rate would be increased to 7%, reducing the margin on deposits >£25,000. The Governor also conveyed the view of the Minister that "It would be helpful in getting the Minister's approval if the banks could recognise and define certain types of productive advances to which a preferential rate might be applied". This was reiterated at a meeting between the Banks and the Minister on 28th February but was rejected by the banks.

Although the banks intended introducing a new revised schedule (in a letter dated 10th March), the banks agreed to defer their decision "until they had an opportunity of studying the measures to be announced in the Dail by the Minister for Finance

²⁵ Most authors identify the November trade figures as the predominant factor for the Minister's decision to increase interest rates. However at that time the government was requesting more temporary accommodation. The Banks stated that owing to their need to conserve external reserves, (banks were selling off their sterling assets to fund lending), they could not sanction the additional £5m requested. In regard to current bills, 3 of the banks were looking for payment of the bills maturing on the 31st December. This may have influenced the Government's decision. The requirement of the banks was that the Central Bank would rediscount Exchequer Bills in whole or in part and this was agreed to by the Central Bank.

²⁶ One would have expected that the Governor would have favoured a larger increase in lending rates given their statements on the causes of the Balance of Payments crisis in 1955. However it would appear that the concern with banks profitability was the principal concern, reflecting his earlier views in the First Banking Commission Report and the increase in bank's profitability during 1955.

intended as corrections to the present unsatisfactory Balance of Payments position” (Meeting of the IBSC with the Minister and the Taoiseach on the 14th March 1956 and again at the meeting on the 14th April, 1956). Again the banks fear of a change in the laws affecting the banking system seems to have been an important factor here. It was raised by the Governor of the Central Bank, in February and explicitly by the Taoiseach in April. “An Taoiseach stated that any action on the part of the banks in raising interest rates must result in a conflict with the government and a demand from many quarters for the introduction of legislation controlling the bank’s powers to increase interest rates without prior government approval. The government would find it difficult to resist such a change”. The Taoiseach referred to the Treasury control of interest rates operating in Great Britain and the difficulty of countering a proposal for the introduction of a similar control in this country. “They had a public duty of working in unison with the government and assisting in the implementation of the government’s general economic policy” (IBSC Minutes, 13th April, 1956)

As there was no change in deposit rates, the banks looked for an extension of the reciprocal relationship between the Irish and the British Banks. The reciprocal arrangement was extended to amounts both above and below £25,000 (23rd April, 1956).

The banks recognised the interdependency between the government’s borrowings from them and their interest rate decision, which they, the government, had imposed on the banks. On 4th May, in a letter to the Minister for Finance, the banks highlighted the difficulties that they face in financing government borrowings given the decline in external assets and in deposit accounts. At the IBSC meeting of 15th June a more explicit connection is made. “A point might also be made to the government that their refusal to increase rates in February 1955 and again in March of this year had been a contributory factor in the Bank’s present inability to provide government finance to the extent required”.

The British Bank rate was reduced to 5% on the 7th February 1957²⁷. It was increased to 7% in September 1957. Irish interest rates were subsequently increased on 30th September. For the remainder of the 1950s, Irish interest rates changed in response to changes in the British Bank Rate.

4.3 Conclusions

The banks no longer had the same independence in setting interest rates. The Government and the Central Bank could make known their views to the banks on their preferred interest rates.

The banks fear of losing their autonomy, acted as a sufficient threat to the banks to get them to reconsider their behaviour. It would seem that this threat disappeared with the new government in place²⁸ and the banks managed to retrieve their margins somewhat by the end of the 1950s. The margin between the Overdraft Rate and deposits >£25,000 ended the decade at 3¾% points (it had been 4% points in March 1952). On the other-hand the margin between the Overdraft Rate and deposits <£25,000 had expanded from 4½% points in 1952 to 4¾% points in 1960.

²⁷ The 15th Dail had ended in December 1956, followed by a new Fianna Fail government in March 1957, led by De Valera.

²⁸ It is also consistent with De Valera’s views on the Irish Banks.

The greater involvement of the Central Bank is clearly evident. It acted as a mediator between the government and the associated banks. In its 1958 report it noted that there was more frequent and closer consultations between the Central Bank, the Associated Banks and the Government. We noted in the 1956 episode that not only did the Governor confer the views of the government it also suggested interest rate changes that it favoured.

The relationship between the Irish bank's interest rates and the British Bank rate was modified during this period. In the earlier discussions on interest rates, banks had constantly re-iterated the need to keep their deposit rates competitive in the UK – the deposit rate on amounts of >£25,000 was kept equal to the London Banks Deposit Rate. This relationship disappears post 1956/57 with the Irish rate usually ½% to 1% below the London Banks Deposit Rate (unlike the Northern Irish Banks which maintained the connection between the rates). They were facilitated in doing this by the arrangement that the Irish banks had made with the London Clearing banks. This greater freedom in setting deposit rates altered the relationship between the Overdraft rate and the British Bank Rate. The difference in the Overdraft Rate and the British Bank Rate, which had been 2% points in March 1952, fell to ¼% points in September 1957, and was subsequently widened to 1¾% points by 1960.

5. Interest Rate Setting – 1960s

5.1 Interest Rate Agreement? – The early 1960s

The role of the Central Bank as mediator, increased during the 1960s. In June 1960, after an increase in the British Bank Rate, the Governor called on the Chairman of the IBSC to stress the pressure that might be forthcoming from government circles against any increase in Republic of Ireland lending rates, given the emphasis in the government policy on increasing exports (IBSC Minutes, 27th June, 1960). Although the banks recognised that there was no justification on economic grounds for the increase in interest rates, competition for deposits necessitated an increase, particularly for deposits >£25,000²⁹.

During the first half of the 1960s, the margin between the Overdraft Rate and the Bank Rate narrowed in times of rising interest rates and widened when the Bank Rate was falling (as a result of banks increasing (reducing) their overdraft rates by ½% point for every 1% point increase (decrease) in the bank rate). Similarly the margin between the Overdraft Rate and the Deposit Rate >£25,000 narrowed when interest rates were rising but widened when interest rates were falling, in line with banking practice. However the margin between the Overdraft Rate and the Deposit Rate <£25,000 remained unchanged at 4½% points.

During the early 1960s, the banks' changed their interest rates about 1 week after the change in the British Bank Rate. This suggests that the interest rate decisions of the banks were consistent with those of the Central Bank and the Government.

June 1965

²⁹ The margin between the Overdraft Rate and the Deposit Rate > £25,000 was reduced from 3¾% points to 3½% points.

On the 5th June, 1965 the British Bank Rate was reduced from 7% to 6%. The banks were asked by the Central Bank to leave interest rates unchanged. The very rapid expansion in bank credit between 1963 and 1965 was having negative consequences for inflation, the balance of payments and the External assets of the Banking System (Central Bank Annual Report, 1965/6). The Department of Finance and the Government concurred with the Central Bank's advice. The banks did express some concern about whether adhering to the advice of the Central Bank and the Government would affect their freedom of action in the future³⁰. The banks adhered to the request and left interest rates unchanged.

1966

The Bank Rate increased from 6% to 7% on 14th July 1966. The IBSC met on 22nd July, 1966. Although the Bank rate had fallen to 6% in June 1965, Irish banks' rates had remained unchanged since November 1964, when the bank rate had been at 7%. The view of the IBSC was that rates needed to be increased to encourage deposits and to discourage borrowers.

The role of the Central Bank as mediator between the Department of Finance and the banks is again apparent here. The Chairman conveyed to the meeting the view of the Governor (Dr. Moynihan) that "if such a decision was reached the Department of Finance might wish to probe its effect on the profitability of the banks" (IBSC Minutes, 22nd July 1966). However the situation appears to have changed because by 10th August, both the Governor and the Department of Finance approved of an early upward adjustment to both lending and deposit rates.

The increasing role of both the Central Bank and the Government in dictating interest rates was of concern to the banks, who wished to maintain their autonomy. The Governor had indicated, to the Press, on the 29th July, that the banks would be increasing rates on deposits and loans which pre-empted the notification by the banks of the interest rate changes to the public³¹ (Central Bank Quarterly Bulletin August, 1966:13).

The banks were also experiencing increasing competition from both the Building Societies and the POSB for funds. Because of this the 7% British Bank Rate in 1966 resulted in a 3½% and a 5% deposit rate (deposits <£25,000 and >£25,000 respectively) in contrast to 2½% and 4% respectively, when the British Bank rate was 7% in 1964. This resulted in a narrowing of the margin.

5.2 Interest Rate Disagreements – the late 1960s

1967

The British Bank Rate was reduced on three occasions in the first six months of 1967 – 26th January, 16th March and 4th May. Irish rates were reduced on only 2 occasions – 31st March and 7th June. The Central Bank favoured no change in interest rates initially given their expectation that interest rates were on the way down. After the second increase, the Governor did favour a reduction in interest rates but he also wanted a reduction in the margin between the Overdraft Rate and the Deposit Rate. He favoured a ½% reduction on lending rates with the minimum loss possible in the

³⁰ It was mentioned in the Dail that "it was decided that rates should not be reduced".

³¹ The banks believed that the Governor was under pressure from the Government to mention this (IBSC Minutes, 10th August 1966).

deposit rates. “The Central Bank is not a price fixing authority but it felt entitled to offer comments on the rate changes where appropriate” (IBSC Minutes, 28th March, 1967).

The primary driver of interest rates was rates by banking competitors. The deposit rate (on amounts <£25,000) could not be reduced below 3% due to competition from the Post Office, which was paying 3.5% at that time. The banks were also expecting increased demand from the government for accommodation, which necessitated keeping resources up and keeping the demand for advances down. The banks needed to compensate for the fall in money market rates with a wider margin. They favoured a 3/8% reduction in the overdraft rate, with a 1/2% reduction in deposits of >£25,000 and 3/4% reduction in deposit rates >£25,000³². All other lending rates were left unchanged. This was introduced on 31st May, 1967.

The Minister for Finance does not appear to have been consulted on these interest rate decisions. In a letter to the Standing Committee, dated 31st March, the Minister expressed his disapproval at their decision – the low reduction in the overdraft rate and no change in special overdraft rates. “The banks without specific consultation with the Department decided to change the relationship between the lending rates on ordinary and special accounts, which emerged as a result of discussion some years ago”. The Minister expected “that a further reduction in lending rates would be expected and he urges that the banks should take an early opportunity to revise the matter”.

The banks concern for retaining their own autonomy from the Department of Finance is clearly in evidence in the discussions on interest rate change in lieu of the further decline in the British Bank rate on 12th May to 5 1/2%. The banks recognised that they needed to co-operate more with the Central Bank as “it would be embarrassing for the Central Bank if the banks continued to refuse advice” (IBSC Minutes, 12th May, 1967). This suggests that the banks modified their behaviour, in line with what the government wanted, in order to reduce their interference³³.

The second half of 1967 was dominated by the increase in interest rates associated with the sterling devaluation of 18th November, 1967. The increase in the British Bank Rate on 19th October was not followed by an increase in Irish rates. The advice of the Central bank was that interest rates should be left unchanged given current Irish economic conditions³⁴. The increase in the British Bank Rate on the 18th November was followed by an increase of 1 3/4% in all deposits and 1 1/4% on overdrafts and advances. This was not in line with the views of the Department of Finance which wanted lending rates to increase by 3/4% points and deposits by 1% point. The Central Bank also wanted to avoid “actions of a deflationary nature” (IBSC Minutes 20th

³² As interest rates on deposits > £25,000 in the Republic (4 1/4%) were now greater than those in the UK (4%), whereas interest rates on deposits <£25,000 were less than those in the UK, the banks looked for a reciprocal arrangement from the UK clearing banks whereby they, the Irish banks, would not pay the higher interest rate on deposit >£25,000 on deposits transferred from the UK and the latter would not pay the higher interest rates on deposits on amounts <£25,000 transferred by Irish residents to the UK.

³³ The margin between the rate on deposits > £25,000 and the overdraft rate was reduced to 3.5% points whereas the margin between the rate on deposits >£25,000 and the overdraft rates was increased to 4.75% points.

³⁴ Despite the fact that this would lead to an increase in banks profits.

November, 1967). It would seem that the reasons given by the banks for their decision - the need to: safeguard deposits from competitors in Ireland and abroad, avoid a significant difference in overdraft rates between Ireland and London which would mean that British subsidiaries in Ireland would increase their borrowings here, distinguish between economic conditions in Ireland and the UK³⁵, plus the resultant reduction in margins did not generate any controversy.

1968

This year was characterised by falling British Bank Rates, to 7½% on the 21st March and 7% on 19th September. The view of the Governor at the time of the first reduction, was that interest rates should be reduced immediately. He also stressed the need to maintain the smaller margin between the lower Deposit Rate and the Ordinary Overdraft rate.

The government published the Capital Budget 1968 which contained the following statement “there is no shortage of credit for productive private Investment and it is reasonable in these circumstances to call on the banks to provide the estimated residual finance required” (IBSC Minutes, 11th April 1968). This concerned the banks for a number of reasons and effectively stalled the change in Irish interest rates until after the second Bank Rate decision in 1968. The banks felt that the government should not have published the programme without prior consultation. They stressed the negative implications that this would have for the Irish economy and they questioned how they could support the financing of the programme and satisfy liquidity requirements. These concerns were also shared by the Governor of the Central Bank who was concerned about “the level of public expenditure, the ability of the economy to accept injections of the order proposed and the ability of the banks to finance the private sector” (IBSC Minutes, 11th April, 1968).

It would appear that the banks were also influenced by the Central Bank who warned in their August Quarterly Bulletin of “inflationary tendencies”.

The banks reduced their overdraft rates and deposit rates to the same rates as in August 1966 when the British Bank Rate had last been 7%³⁶. However other rates on collateral loans and special loan rates were not reduced to the same degree, suggesting a response by the banks to the “inflationary tendencies”.

1969

A new Governor, (Dr. Whitaker) was in place for the next British Bank Rate increase to 8% on the 27th February, 1969. The increase in inflation and balance of payments deficits dictated the Central Bank’s views on interest rate increases. In their view “primary attention should be given in this context to the production of liquid monetary resources and the restraint in lending” (IBSC Minutes, March 10th, 1969). The Central Bank suggested the actual size of the interest rate increase that should be introduced (See Table 5). These increases were greater than those favoured by the Department of Finance.

³⁵ “The Irish economy was at present strong and the bank’s must encourage rather than inhibit business confidence” (IBSC Minutes, 20th November 1967).

³⁶ The Department of Finance had also made it clear that it would increase interest rates on Post Office Savings if the Associated Banks left their rates at a high level.

The banks concurred with the Central Bank, favouring a 1% increase all round in lending rates to deter borrowers and encourage depositors. However these changes by the banks enabled them to maintain their margins. In contrast, as pointed out in a letter sent by the Governor to the Standing Committee, after the change, the Central Bank had favoured a reduction in the margin on deposits <£25,000. Although the Central Bank did not object to the banks' decision "it is however a consideration which might appropriately be taken into account on the occasion of a future review of interest rates" (Letter dated 12th March, 1969).

Table 5: Central Bank, Department of Finance and the Banks' Interest Rate Decisions, March 1969

	Central Bank	Department of Finance	of Banks
Deposits <£25,000	4¾% (+1 ¼%)	4½% (+1%)	4½% (+1%)
Deposits > £25,000	6% (+1%)	6% (+1%)	6% (+1%)
Overdraft Rates	9% (+1%)	8 ¾% (+¾%)	9% (+1%)

5.3 Conclusions

Interest rate setting in the 1960s differed from that in the 1950s in a number of ways. The role of the Governor of the Central Bank increased both as a conveyer of messages from the Government and in its own right. Its view was that although it was not a price fixing authority, it was entitled to offer comments on the rate changes it considered appropriate (IBSC Minutes, 28th March 1967). Direct interference from the Minister for Finance also appears to be less and in some cases the Minister appears not to have been consulted in advance of the interest rate change. By 1970, the view of the then Governor, Dr. Whitaker, was that any change in interest rates was a matter for a decision by the Associated Banks in consultation with the Central Bank (IBSC Minutes, 17th April, 1970). The banks also began to recognise the importance of co-operating with the Central Bank as this could provide effective protection against government interference.

Threats were still employed by the Government to affect interest rate decisions. However the threats are different and are generally focussed on investigations into bank profitability (IBSC Minutes, 22nd July, 1966) and bank charges (IBSC Minutes, 10th March, 1967), and possible changes in POSB rates (IBSC Minutes, 28th September, 1968). The above two were real and would have had undoubtedly public support. Whether these threats were actually effective and did lead to a modification of behaviour needs further investigation³⁷.

There was undoubtedly greater opportunity for independence in the setting of interest rates. Although balance of payments deficits were significant in particular years, greater capital inflow, helped to ensure that these deficits were financed. The banks also were facing a new competitive environment for funds from the POSB, the Building Societies and the non-Associated Banks and this receives more discussion in the Minutes than the threat of the loss of deposits to the UK. Finally issues to do with

³⁷ Although margins certainly fell at different stages during the 1960s.

government financing continued to affect the banks' response to government and the central bank's recommendations.

6. Conclusions

This paper has analysed how the instrument independence of the Central Bank and the Associated Banks was affected during the 1950s and the 1960s. We examined, using the Irish Banks Standing Committee Minutes, how the Minister for Finance and the Government intruded into interest rate setting by the banks and how threats to the banks' autonomy may have affected their behaviour. We also noted the increasing role played by the Central Bank.

This research raises a number of further questions for investigation:

We noted, during the 1950s and 1960s, how the Government utilised the powers granted to it by the Central Bank Act 1942. Therefore it is necessary to investigate the rationale behind its original institutional design (Berger and De Haan, 1999). The design of the Central Bank is itself endogenous. Cukierman (1992) has suggested a number of factors that may affect the degree of independence awarded to a Central Bank in its statutes. These are: (i) the degree of political instability; (ii) the nature of the financial markets and the extent of financial intermediation; (iii) alternative supplies of funds; (iv) whether a country is a developed or a developing one; (v) whether there is a large outstanding internal debt and (vi) the size of shocks facing the country. These factors may also be important in affecting the decision by various governments to utilise the statutory powers given to them. Like Cukierman (1992), Posen (1995) has identified that the financial sector can play a critical role in affecting the degree of central bank independence. Their role needs to be investigated in the Irish context. Additionally the initial and indeed changing preference of policymakers (i.e. their conservatism) needs to be reviewed.

At this stage, we have only investigated times when the change in the Irish interest rate lagged behind the change in the British Bank Rate. We need to extend our examination to those times when Irish interest rates immediately (i.e. a lag of approximately a week) followed British rates.

We also need to examine how the banks' financing of government expenditure interacted with their interest rate decisions, suggesting coordination problems for the two players.

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Appendix

Table 1: GMT Measure of Political Independence (* indicates indicator of independence)

(i) Appointment Procedures	Ireland	
Governor not appointed by the Government	Governor appointed by the President on the advice of the Government	
Governor appointed for >5 years	Governor's statutory term was 7 years	*
All the Board appointed by the Government	3 Banking Directors appointed by the Minister for Finance from a panel prepared by the representatives of the Associated Banks. 2 Service Directors: both permanent Civil Servants, appointed by the Minister for Finance. 3 General People (representing Business, Farming and the Trade Union Movement), appointed by the Minister for Finance.	
Board appointed for > 5 years	Initial appointments of 2 of the first Banking Directors determined by lot and their terms of office were 2 and 4 years. The normal term of office is 5 years. Initial appointments of 2 of the "General People" Directors for 1 and 3 years. The normal term of office is 5 years. Service Director's appointment at pleasure of the Minister and may be removed by the Minister at any time.	
(ii) Relationship between these Bodies & the Government		
No mandatory participation of government representatives on the Board	2 permanent civil servants on the board	
No Government Approval of Monetary Policy formulation is required ³⁸	The Minister may request the Governor or the Board to consult and advise with him in regard to the execution and performance by the Bank of the general function and duty imposed on the Bank and the Board shall comply with every such request.	
(iii) Formal Responsibilities of the Central Bank		
Statutory requirements that central bank pursues monetary stability amongst its goals	The bank shall have the general function and duty of taking (within the limit of the powers for the time being vested in it by law) such steps as the Board may from time to time deem appropriate and advisable towards safeguarding the integrity of the currency and ensuring in what pertains to the control of credit, the constant and predominant aim shall be the welfare of the people as a whole.	*
Legal Provisions that strengthen the Central Bank's position in conflicts with the Government are present	None	
	Total	2

Source: Grilli, Masciandaro and Tabellini, 1991: 368; Central Bank Act, 1942

³⁸ GMT (1992) state that no government approval of monetary policy is required for their period of investigation, suggesting independence on this measure.

Table 2: GMT Measure of Economic Independence (* indicates indicator of independence)

(i) Monetary Financing of the Budget Deficit	Ireland	
Direct Credit Facility: Not automatic		
Direct Credit Facility: Market Interest Rates		*
Direct Credit Facility: Temporary		*
Direct Credit Facility: Limited Amount		*
Central Bank does not operate in primary market for public debt	Buy, hold or sell securities of or guaranteed by the State which have been offered for public subscription or tender before being bought by the Bank.	*
(ii) Monetary Instruments		
Discount Rate set by the Central Bank	Fix and Publish from time to time, the minimum rate or rates at which the Bank will re-discount such Exchequer bills, bills of local authorities, or bills of exchange.	*
Banking Supervision not entrusted to the Central Bank	No	
	Total	5

Source: Grilli, Masciandaro and Tabellini, 1991: 368; Central Bank Act, 1942

Table 3: Cukierman's Classification of the Independence of the Irish Central Bank, 1950s.

Classifications	Definition of Variable	Levels of Independence and their Meanings	Numerical Codings
Appointment, Dismissal & Terms of Office of the Governor	Term of Office	7 years	0.75
	Who Appoints?	President on the advice of the Government	0.5
	Provisions of Dismissal of Governor	Dismissal possible only for non-policy reasons	0.83
	Is Governor allowed to hold another office?	Prohibited by law from holding any other office in government	1
Who Formulates Monetary Policy?	Who formulates Monetary Policy?		NA ¹
	Government Directives & Resolution of Conflict		NA
	Is the CB given an active role in the formulation of the government budget?	No	0
CB Objectives	Price Stability	Price Stability is the only goal	0.8
Limitations on Lending	Limitations on Advances	Not mentioned	NA
	Limitations on Securitised Lending	No legal limits- their quantity subject to periodic negotiations between gov and CB	0
	Who decides control of terms of lending?	Law leaves the decision about the terms of CB lending to government to negotiations between CB and Executive	0.33
	How wide is the circle of potential borrowers from CB?	In addition to Central Government, also public enterprises	0.33
	Type of Limit when such limit exists		NA
	Maturity of Loans	Maturity of CB loans limited to a maximum of 1 year	0.66
	Restrictions on Interest Rates	Interest rate on CB loans to government cannot be lower than a certain floor	0.75
	Prohibition on Lending in Primary Market	CB not restricted from buying gov securities in primary market	0
	Total		0.39

¹The code NA is assigned whenever there is insufficient information contained in the charter.

Source: Cukierman (1992): 398-414

Table 4: Comparison between Interest Rate Schedule 1925 and Interest Rate Schedule 1935

Interest Rates	1925	1935	Difference
British Bank Rate	6½%	6½%	
Irish Trade Bills	7%*	7%*	0
Overdraft on Government Stock, Bank Stock or other Marketable Securities	7%*	7½%	+
Collateral Loans on Transferred Marketable Securities other than Government or Bank stock	7%*	7½%	+
Collateral Loans on Transferred British and Irish Government Stock	6.5%	7%*	+
Other Overdraft Accounts and Bills	7.5%	7.5%	0

Note: *signifies the Irish Banks' Rate

Source: Irish Banks Standing Committee Minutes, various issues.

Fig. 1: Overdraft Rate, Irish Banks Deposit Rate & British Banks Rate 1952 - 1960

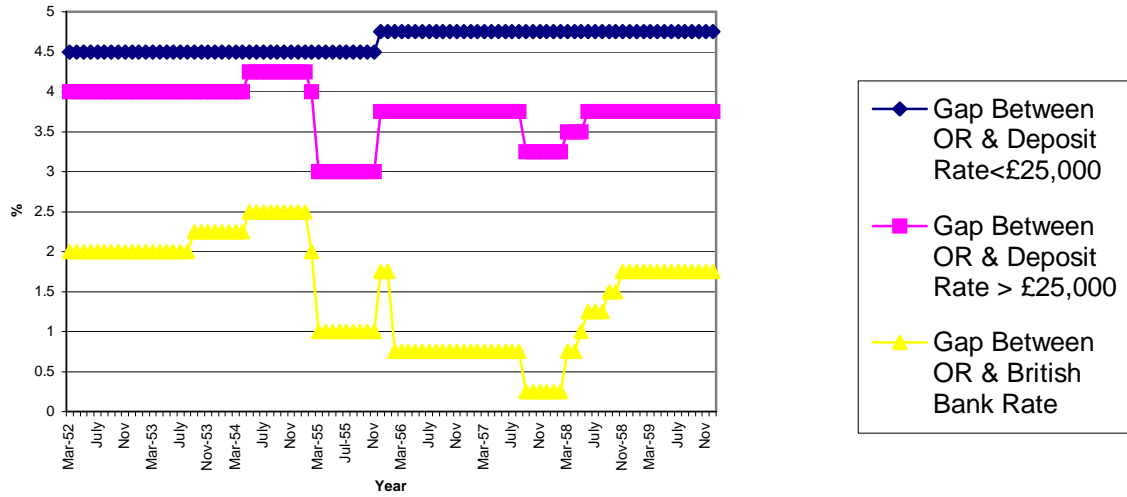


Fig. 2 Overdraft Rate, Irish Banks Deposit Rate & British Bank Rate 1960-1970

