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THE IRISH MACROECONOMIC CRISIS OF 1955-56: HOW MUCH WAS DUE TO MONETARY POLICY?*

1. Introduction

The macroeconomic crisis of 1955-56 was the defining event of post-war Irish economic history. What had been an underperforming economy slid into deep recession for reasons which were poorly understood. The long-term consequences were considerable: the reorientation of economic policy that resulted led to the restructuring and expansion of manufacturing on the basis of tax- and grant-aided foreign direct investment to a degree which today continues to be unparalleled. On the political front, the crisis led to the Fianna Fáil party being returned to office and holding it for 16 years.

The main symptoms of the crisis are well known. A severe current account deficit and drain of foreign assets in 1955 was followed by a restrictive budgetary policy in 1956. GNP dipped, recovering to its 1955 level only by 1958; emigration soared. But what triggered the crisis? In contrast to contemporary and subsequent commentators who stressed other aspects, this paper examines the extent to which monetary policy can be blamed. The Irish authorities responded inappropriately to interest rate increases and a policy of credit restraint introduced in the UK. At the time, this was seen as a monetary policy experiment, breaking the mould of conservatism and slavish adherence to financial conditions determined in London and implemented by Victorian-style banks. But, though the radical critique of the financial establishment was not unfounded, the experiment proved to be a failure.

The paper is organized as follows. Section 2 describes the sequence of events as the crisis unfolded. Section 3 assesses the degree to which the fall in foreign assets could be attributable to the failure to match the tightening of credit policy in the UK. Section 4 discusses the policy debate. Section 5 describes the reaction of the banks. Concluding remarks are in Section 6. There are two Annexes, the first of which covers trends in credit before and after the crisis, while the second provides background details on the decomposition methodology used in Section 3.

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2. The crisis unfolds

As told in the standard accounts, the story begins with the emergence in 1955 of a current account balance of payment deficit. Having run at between 1 and 2 per cent of GNP during 1952-54, the current account deficit jumped to 6.5 per cent in 1955. At the same time the net foreign assets of the banking system, which had been rising steadily since the end of 1951, tumbled by about 8 per cent of GNP. Although the decline in foreign assets amounted to only 18 per cent of the total net foreign assets of the banking system (still swollen by wartime surpluses), the situation was evidently unsustainable.¹

Responding in March 1956 to the crisis, the Government imposed heavy supplementary import duties on a range of finished and semi-finished consumer goods. This was effective in reducing the current account deficit to 2.5 per cent of GNP in 1956 and turning it into a surplus by the following year. The net foreign assets of the banking system also began to turn around by early 1957.

Effective as it was in reducing imports, the fiscal contraction also hit the real economy, inducing a domestic recession and resulting in a surge of emigration. GNP fell by 1.3 per cent in 1956, and recovered by only 0.5 per cent in 1957.² The impact on employment and emigration was especially severe. Following the usual propagation pattern of a labour market shock in Ireland, it showed up first in unemployment, and then (after a lag of some quarters) was absorbed in emigration with little or no permanent impact on unemployment. Thus, registered unemployment peaked in January 1957, having increased by more than 2 per cent of the labour force. Net emigration, already running at high levels, soared during 1957 to about 1.8 per cent of the population, a figure which has not since been matched. The fiscal response to the crisis is widely thought to have been overdone, and the finger is usually pointed mainly at fiscal policy as the area in which errors were made.

So far, the story does not involve much in the way of monetary policy. However, it cannot be ignored that, in January and February of 1955, London Bank Rate was raised in two steps by 1.5 per cent (to 4.5 per cent). It is not that this interest rate increase in itself adversely affected Irish economic activity, but the Irish policy response to it did. The Irish banks would normally have followed suit by raising their interest rates by the same amount or close to it.³ But on this occasion they were persuaded by

1 The earlier and larger balance of payments crisis of 1950-51 was largely due to the terms of trade effect of the 1949 sterling devaluation and the Korean war commodity price boom. Receipt of Marshall Aid funds helped up to 1951, but a deflationary budget was introduced in 1952 which proved more than enough to correct the situation.

2 These figures differ somewhat from those published in the 1950s. They are based on a revised database maintained at the ESRI.

3 Cf. Patrick Honohan and Charles Conroy, *Irish Interest Rate Fluctuations in the European Monetary System* (Dublin, 1994).

the Minister for Finance to refrain from a corresponding increase in bank lending rates. Deposit rates for balances smaller than £25,000 were not increased in line either. This was the first time that the Government had successfully influenced bank rates to this extent, and it was not until December 1955 that the Minister suddenly gave way, observing that the balance of payments situation had deteriorated so that the conditions no longer permitted rates to be held down.

The 1955 interest rate decision both introduced a wedge between London and Dublin, and lowered the real cost of funds, considering that inflation accelerated from less than 2 per cent in 1954 to more than 4 per cent in 1955. As is explained in the next section, it is possible to interpret the balance of international payments crisis that ensued as being in no small part attributable to the emergence for the first time of a substantial interest differential.⁴ In this context it is important to recall that there was complete freedom of capital movements between Ireland and the rest of the Sterling Area. Thus, even if the fiscal authorities over-reacted to the balance of payments deficit and the drain of foreign assets, the origins of the problem may partly lie in a prior monetary policy failure.

3. Sources of the payments drain

The literature provides no conclusive interpretation as to why the 1955 crisis occurred. In this section, we suggest that the failure to increase interest rates in line with London may have had a greater role than has previously been recognized in causing the drain in foreign assets, thereby prompting what proved to be an excessive policy response.

Previous studies have stressed the current account deterioration and in particular the role of increased consumer expenditure in inducing growth of imports. The most thorough analysis⁵ provides several explanations for the import boom, including the impact of a generalized wage increase on consumer spending, speculative accumulation of inventories related to import price increases and a credit boom. Contemporary accounts seem to have placed most emphasis on the expansion of consumption demand,⁶ and this was certainly the aspect which was addressed by the policy measures of 1956.

4 The unsustainability of the interest rate policy is trenchantly expressed by James Meenan: 'It was officially stated in Dublin that "the banks had accepted that the different circumstances obtaining in the Republic made it unnecessary to follow the British changes". There is no reason to believe that the banks held this opinion with conviction, or indeed that they held it at all. However tenable it may have been in early 1955 it became less and less so as the year went on with its gloomy sequence of increasing trade deficits, loss of external assets and, most alarming of all, the conjunction of falling deposits and rising advances.' J. Meenan, *The Irish Economy Since 1922* (Liverpool, 1970), p. 237.

5 Kieran A. Kennedy and Brendan R. Dowling, *Economic Growth in Ireland* (Dublin, 1975).

6 The Central Bank of Ireland's 1955-56 *Annual Report* (for the year ending March 1956) stresses that, in contrast to Britain and elsewhere, in Ireland '1955 was essentially a year of rapid increase

In contrast, we will now show that almost a half of the deterioration in foreign payments was accounted for by a turnaround in non-bank private capital flows. This turnaround in capital flows was substantially larger than the increase in imports stressed by others.⁷ Furthermore, a fall in exports, relative to trend, was a sizable additional factor.

Monetary policy is likely to have contributed to the net capital outflow. Not only will lower real interest rates have increased the demand for bank credit, but there may also have been a substitution of Irish bank credit for British. The interest rate differential will have been a factor, as well as the credit restraint which was urged on the London Clearing Banks from July 1955 on. Certainly (as discussed in Section 5 below) there was a large surge in bank credit, especially to sectors likely to have had pre-existing credit lines in the UK. The remainder of the fall in the net foreign assets of the banking system was associated with a sharp increase in imports and a decline in meat exports. Much of the fall in exports and some of the growth in imports was related to inventory accumulation. The relatively low real interest rate may have helped induce this accumulation.

Quantification

The fall in net foreign assets of the banking system in 1955 came to £42 million (or somewhat more if we include the fall in Departmental Funds' sterling holdings). This compares with a total increase of £16 million over the two previous years. Thus the 1955 event involves a deterioration of £50 million relative to the average experience of 1953-54.

In order to assess the relative importance of imports, exports and capital flows in contributing to this turnaround, we begin by comparing the actual data for the macroeconomic aggregates with the values they would have taken had they retained the same share of GNP as in 1953-54.⁸ This

in consumption' and attributes this to unabated growth in 'social demands upon the available resources' which would not be reversed so long as the 'cherished panaceas for solving our social problems by increasing money supplies and money incomes hold sway'. Ryan's less rhetorical but also contemporary analysis also emphasizes consumption demand, though he does acknowledge a contributory role for interest rates (W.J.L. Ryan, 'The Irish Balance of Payments', *Administration*, iv, No. 3 (1956), pp. 49-55).

7 Kennedy and Dowling do consider the role of capital flows (*Economic Growth*, pp. 51-3, 224-5). They point out that these flows were already weaker in 1954 than in 1953. In addition to the interest rate effect, they mention as possible explanations of this reversal of flows the general pressure on sterling, a possible specific confidence factor relating to the Irish pound and associated with the current account deficit, and a supposed decline in profitable investment opportunities. The Central Bank's 1955-56 *Annual Report* also refers briefly to the increased nonbank holdings of external securities as an indication of the 'incompatibility between striving to maintain low interest rates at home and, at the same time, hoping to induce Irish holders of external assets to repatriate them'. Astonishingly, this is the only reference to interest rates in a 40 page review of economic developments in the Bank's report for the year.

8 Of course this is very imperfect, as it supposes the same GNP in the counterfactual. Real GNP growth in 1955 was 2 per cent.

suggests excess imports amounting to £17 million and a turnaround in private non-bank capital flows amounting to £22 million.⁹ In addition, exports underperformed by £10 million. Between them, these three elements account for almost all of the £50 million turnaround in the movement of net foreign assets.¹⁰

The source of the *excess imports* may be found in both consumption and investment. Consumption rose partly due to a higher share of personal disposable income (there was a substantial pay settlement in that year) and a fall in the savings ratio (Figure 1).¹¹ Investment in fixed capital and stock accumulation were also both above trend.¹² The impact on imports would depend on the propensity to import out of investment and consumption. As we cannot draw on established econometric findings for these propensities,¹³ we assume for 1955 the not unreasonable marginal propensities to import out of consumption demand of about 0.6 and out of investment of about 0.9, to obtain a breakdown of the different causal elements in the excess import flow for that year as shown in Table 1. (The underlying methodology is spelled out in Annex 2).

We now turn to consider to what extent the emergence of an interest rate gap might have caused each of these five identified components of the fall in net foreign assets.

The items least likely to have an interest rate explanation are *savings* and the *wage increase*. Consumer credit was very little developed and the bank interest rates would not represent an opportunity cost for many households. Likewise, although employers' willingness to agree to the wage settlement might have been influenced by lower real interest rates, any such effect would be slight.

The item *investment* included in the Table includes accumulation of stocks (inventories). Contemporary accounts speak of speculative imports of

9 It is true, as noted by Kennedy and Dowling (*Economic Growth*, p. 224), that net capital inflows were a little below average already in 1954, but the main change was in 1955. Looking at the detailed components of the capital account, while identified non-bank capital transactions (especially brokered securities trading and public issues of securities) show little net trend in 1953-55, there is a big turnaround in the 'other' capital transactions of the balance of payments in 1955. Specifically, (a) inflows (e.g. borrowing from foreign banks) average £12.6 million in 1953-54, but only £1.7 million in 1955 and (b) outflows (e.g. deposits in foreign banks) average only £0.8 million in 1953-54, but jump to £9.3 million in 1955.

10 A fall of £42 million following increases averaging £8 million.

11 Despite the stress that others have laid on this, it is evident from Figure 1 that the savings ratio for 1955 is well within previous fluctuations, and does not represent an outlying observation. Of excess consumption amounting to £16.5 million, £10.8 million may be attributed to the lower savings and the remainder to higher personal disposable income.

12 The former by £4.2 million, the latter by £9.0 million, of which £3.5 million represents agricultural stocks. It is not clear how much of non-agricultural stock accumulation in 1955 represented stocks of imported materials.

13 The extensive econometric work on the determinants of Irish imports all relates to later periods and much of it to more disaggregated data sets.

TABLE 1
ANALYZING THE BALANCE OF PAYMENTS
DETERIORATION IN 1955

A: Decomposition of fall in net foreign assets of the banking system		
	£ million	% of fall in NFA
Fall in net foreign assets	50	100
Import excess	17	34
Export shortfall	10	20
Turnaround in net private capital	22	44
Other	1	2

B: Decomposition of import excess		
	£ million	% of fall in NFA
Import excess	17	34
Lower savings ratio	6	12
Wage increase	3	6
Investment increase	8	16

Note: The table shows the difference between the actual flows in 1955 and those estimated on the basis of unchanged relationships from 1953-54. For import excess, export shortfall and net private capital, the benchmark is unchanged ratio to GDP; the decomposition of import excess assumes constant propensity to import out of consumption and investment and is relative to a benchmark of unchanged saving ratio of personal disposable income and unchanged investment share in GDP.

materials which would fall into this category. A build-up of international tension surrounding Suez might have contributed. The interest rate policy certainly lowered the cost of such speculative purchases.

Even the *export* underperformance may have something to do with the interest rates. It is wholly attributable to a fall in meat exports, and there was a corresponding increase in inventories of live animals. It would be a mistake to attribute the fall in exports to a diversion of production to meet an increase in local final demand.

The most obvious element where a substantial interest differential with London contributed to the fall in external reserves is in the *net private capital* outflow (non-bank) which was recorded in the balance of payments account. This might have included switching of small deposits to higher yielding accounts in the UK: non-government deposits at Irish banks fell by £8 million during 1955. However the fall in deposits need not necessarily reflect deposit switching, and it seems likely that small deposits were not

very interest sensitive.¹⁴ More likely to have been significant would be repayment by non-financial enterprises of borrowing from UK banks with the proceeds of borrowing at lower rates from Irish banks.

Sectoral analysis of bank credit suggests that the credit switching route may have been important. Irish bank credit jumped by £24 million in the twelve months to October 1955, representing about three times the rate of nominal GNP growth (or in cash terms an excess of £17 million). While some of the excess is undoubtedly attributable to the financing of the higher inventories we have noted, it is worth mentioning that nearly all of it is accounted for by four sectors 'mining and manufacturing', 'wholesale merchants', 'public bodies' and 'shipping and shipbuilding, transport and communications, electricity and gas'. These sectors probably include many of the more important enterprises and bodies that might previously have been in a position to obtain bank credit in the UK. The fact that the last-named sector was the one whose credit expanded most rapidly in the UK during 1954-55 and shrank most rapidly in 1955-56 may also be a pointer.

Thus, as much as three-quarters of the fall in foreign assets during 1955 can be attributed to interest-sensitive flows. Relative to a 5.5 per cent ordinary overdraft rate, the one percentage point differential represented a substantial gap. Although we cannot say with precision how much less the fall would have been had interest rates followed London, it seems likely that this was a material factor, pushing the decline from what could perhaps have been regarded as a normal fluctuation into the crisis zone.

4. Who made the decisions and why?

The sharp rise in UK bank rate to a level (4.5 per cent) that had not been seen for over twenty years must have seemed like a golden opportunity for the incoming Inter-Party government to flex their muscles and take an action which would match the declaration of the Republic under the previous inter-party regime. It was still, perhaps, a gamble which could more easily be adopted by a Minister from a party with a conservative image.

The new Finance Minister, Gerard Sweetman, was evidently very satisfied to be able to respond to a Parliamentary question on March 4, 1955 that he had discussions with representatives of the Irish Banks' Standing Committee on the implications of the recent change in the bank rate in Britain: 'I represented to the banks that the conditions underlying the increase in Britain do not operate here at present. Recognizing this the banks, in the national interest, decided not to make any change in their lending rates here. I should like to express my appreciation of this decision'. In fact, the full situation was less cordial. The minutes of the Irish Banks' Standing Committee (IBSC) reveal that the Minister had

threatened to seek special powers from the Government to prohibit the banks from increasing their rates.

Did the authorities pause before acting in this way? One indication of the factors that they might have weighed is provided by a memorandum prepared by John O'Donovan, Parliamentary Secretary to the Government and dated 25 February 1955 (the day after the second UK Bank Rate increase). The memo argued that there was no reason to increase interest rates in line with the UK. The line of argument presented is revealing for its enumeration of the elements that might stand in the way of an independent interest rate policy.

First, O'Donovan reasoned, there was no argument for an increase in Irish interest rates on lines of good neighbourliness: the need for an interest rate increase arose only from British inflationary conditions; there was no onus on Ireland to support this policy, especially as Ireland had not been recently been drawing on the sterling pool. Second, the profitability of banks was such that they could afford to carry a rise in the deposit rate if necessary without pushing up lending rates.¹⁵ Third, there was no risk to Ireland: 'our balance of payments is in good order, and all the evidence is that it will remain in good order'. There was 'cogent evidence that much of the deposits in the Irish banks [would] not even cross a street in a town to the local post office, much less cross to England'. These arguments are listed in order of their degree of accuracy in the circumstances of 1955. So far as British reaction was concerned, it is doubtful that adverse sentiment went much beyond surprise.

The profitability of banks was also healthy: in aggregate they had returned about 1.1 per cent of total deposits as taxable profit on average over 1944-53, though the 1952-53 numbers were rather smaller (Figure 3).¹⁶ Because of the substantial net external asset position of the banks, the rise in UK rates would have added substantially to their profits. At the same time, of course, it had the effect of increasing the opportunity cost of lending at home. However, it is clear that the expressed optimism concerning the balance of payments was quite unfounded.

There may also have been a greater willingness to adopt a more ambitious pro-development stance in the Department of Finance, who were the driving force behind financial policy. Over the years, and especially since 1952, Department of Finance officials had negotiated with the banks on the terms for financial support to Government. Typically this was in the form of a subscription to long-term bonds but, by 1952, the banks were

¹⁵ Department of Finance files reveal that bank profitability calculations were made on all subsequent occasions that interest rate issues arose.

¹⁶ The figures are as reported to the Revenue Commissioners. Banks' published profits were much lower, of course, because of the practice of hiding substantial profits in order to give an impression of smooth profitability.

¹⁴ Note also that the fall was disproportionately in non-interest bearing current accounts.

also providing short-term accommodation. The Department of Finance had a direct interest in keeping interest rates down. Bearing in mind also that three of the Central Bank's directors were appointed by the banks, it is not surprising that it was from the Department of Finance rather than the Central Bank that an initiative to influence bank interest rates would come. All the more so given the recent change in personalities at the head of the two institutions.

In 1953 Joseph Brennan, first Governor of the Central Bank, and before that the first Chairman of the Currency Commission, had resigned following protracted policy disagreements with successive governments. From one point of view it can fairly be said that his rigid policy stance had helped ensure financial stability over three decades. On the other hand, his bleak conservatism inhibited all financial experimentation. His successor, J.J. McElligott, who had taken over from Brennan in 1926 as Secretary of the Department of Finance, was also a conservative figure, though intellectually more flexible and somewhat more disposed to employ the tools of central banking in an active pro-development manner. But the departure of McElligott from the Department of Finance, and the caretaker appointment as Secretary of 62 year old O.J. Redmond,¹⁷ left the coast substantially clear for the more radical Keynesian views of a younger generation led by T.K. Whitaker.

In the financial sphere, this radicalism tended to include advocacy of central bank financing of the Government deficit, or 'admission of Irish Government securities to the Legal Tender Note Fund' as it was described in the insular jargon of the day. But it also extended to more reliance on bank financing and preferably at low interest rates. Already in June 1953, Whitaker was writing that 'high taxation and high interest rates are tending to depress economic activity . . . there is nothing revolutionary in the proposal that the Irish commercial banks, who have so long been spared by fortuitous circumstances from having to make any large continuing loans to the Government, should now begin to follow the example of similar institutions in other countries . . . The days of mere temporary accommodation from the banks for State capital purposes are over'.¹⁸ These were not unreasonable views given the fact that total bank accommodation of (central) Government had only just passed ten per cent of the banks' aggregate portfolio, but they certainly indicated the direction of the emergent thinking.

It might at first sight seem surprising that it was a Fine Gael Minister for Finance who took these actions, rather than the populist and nationalist

Fianna Fáil. But, over the years, no political party had a monopoly of financial conservatism, or of financial radicalism.¹⁹ Early financial market anxieties about the likely policies of Fianna Fáil when they came to office in 1932²⁰ were quite soon substantially laid to rest by the financial conservatism of key figures such as Sean McEntee, who was backed in this respect by Eamon de Valera; though that party also included the much more financially radical Frank Aiken and the interventionist Sean Lemass.²¹ On the other side of the house, the cautious policies which had been pursued by the Cumann na nGaedheal government of the 1920s should not be allowed to conceal the pro-development stance taken by such figures as Patrick McGilligan in the first Inter-Party government, especially in regard to the planned deficit budgeting of capital expenditure in the Public Capital Programme introduced for the first time in 1950.

Nevertheless, it is noteworthy that only three years earlier in March 1952, the Fianna Fáil government had been contemplating a similar attempt to resist upward pressure on interest rates coming from London. On that occasion Joseph Brennan 'in long separate discussions' with de Valera and McEntee steered them away from the path taken by their predecessors.²²

Was official advice less categorical or forceful in 1955? Available official files do not provide the necessary information, so far as the Department of Finance is concerned. We are told by the official historian of the Central Bank that the new Governor (McElligott) did make representations, both oral and written, on the interest rate matter, to Minister Sweetman in February and March 1955, but that these were unsuccessful.²³

Even though many opposition politicians would have shared the policy preference for lower interest rates, Fianna Fáil did not lose the opportunity to criticize the action. McEntee and others argued that the decision would lead to an outflow of deposits to the UK and would ultimately curtail

19 Among examples of such radicalism expressed by prominent members of the establishment are P. Lynch, 'The Economist and Public Policy', *Studies*, xlii (1953), pp. 241-60, and J.P. Colbert, 'Irish Banks and Irish Public Credit Facilities', *The Statist*, 24th October 1953 (cited by Maurice Moynihan, *Currency and Central Banking in Ireland, 1922-1960* (Dublin, 1975), p. 411).

20 C. Ó Gráda, *Ireland: A New Economic History* (Oxford, 1994), pp. 369-70.

21 Moynihan, *Currency and Central Banking*, pp. 409, 415.

22 Leon Ó Broin, *No Man's Man: A Biographical Memoir of Joseph Brennan* (Dublin, 1982), pp. 161-2.

23 Moynihan, *Currency and Central Banking*, pp. 421-2. Furthermore the public statements of the Central Bank were impeccably conservative, at least after the event, as evidenced by the remark in its October 1956 *Quarterly Statistical Bulletin* (p. 4) that 'There does not appear to be sufficient recognition of the fact that in our circumstances, in face of the now universally established upward trend in rates of interest, the pursuit of cheap money can result only in scarce money'. See also the 1956-57 *Annual Report* of the Bank, which observes (p. 41) that 'overestimation of the value in Irish conditions of technical methods of Central Banking in use elsewhere tends to distract attention from the basic defects in Irish economic policy and to encourage the dangerous - and profoundly mistaken - belief that prosperity can be attained by financial devices'.

17 But note that Redmond was not appointed to the vacancy created on the Central Bank board by McElligott's assumption of the Governorship.

18 Quoted in R. Fanning, *The Irish Department of Finance, 1922-58* (Dublin, 1978), pp. 493-4.

credit.²⁴ The first of these happened at most to a modest extent.²⁵ The second certainly did not happen. More prescient was McEntee's prediction that the Minister's attempt to take control over interest rates would create expectations which would prove to be difficult to live up to.

In the parliamentary debate that ensued, UCD Economics Professor George O'Brien reiterated the textbook view that 'English and Irish bank rates will tend to move together in the long run . . . that any holding of rates is essentially a temporary measure'. Still, there remained a degree of ambiguity as to how far one could push interest differentials with Britain. The Irish banks had widened the average gap between their own bill rate and London Bank Rate following independence²⁶ and had lowered deposit rates during the war. It was widely commented that the banks could still attract deposits at 1 per cent when the Post Office was offering 2.5 per cent.

5. Bank Behaviour During and After the 1955 Crisis

In attempting to understand how the banks reacted to the new situation, it is helpful to recognize that the main Irish banks had long practised a very traditional type of British banking, relying chiefly on self-liquidating short-term overdraft lending and bills. They held very substantial liquid assets in British government securities. They operated under a regulatory structure wholly inherited from before independence, with the establishment of a central bank from 1943 being of very little consequence to banking in practice.²⁷ They acted as a cartel, not only in setting interest rates, but in all aspects of their dealings with the Government.²⁸ Against this background, the Irish Government's initiative to push down bank interest rates must have come as an unwelcome surprise to the banks.

It was not the first time that the Government had pressured the banks in the direction of lower interest rates. For example, in March 1952 the Irish Banks' Standing Committee (IBSC), meeting to consider their response to the 1.5 percentage point increase in London Bank Rate, had to contend with a specific request from the Government to delay any action until the Government had time to consider the matter – though on that occasion (as

indicated above) the banks got their way and without much delay. Moynihan (1975) describes another episode in May 1954, when the banks were persuaded to go further in lowering overdraft rates than they had proposed, though the additional concession applied only to lending under Government guarantee and to State-sponsored bodies (IBSC minutes of 20 May 1954).

A reading of the minutes of IBSC meetings in the period 1952-56 indicates that the banks were unhappy with such pressure for three main reasons. First, as a matter of principle they did not want to have the making of interest rate decisions taken out of their hands. The risk to public confidence in the banking system is mentioned, but there is also a wider concern that this path could lead to the banks effectively losing their autonomy. Their 'utter opposition' to the idea of any announcement of increased interest rates being made by the Minister (19 December 1955) may be taken as illustrative of this concern. Second, they were concerned about their ability to fund credit demand through deposit growth if deposit interest rates were restricted. This concern is easy to understand given that, during 1955, the banks had to reduce their holding of British Government securities by an amount sufficient to fund more than 15 per cent of domestic lending. The banks were particularly anxious to avoid an interest rate differential *vis-à-vis* Northern Ireland on large deposits. Third, they were concerned about profitability. In the short-run, the Government's insistence that the matrix of interest rates should not be increased will have tended to help bank profitability, especially while there were such substantial net external assets. This is acknowledged by remarks made at IBSC meetings in September and November 1955. Higher interest rates on large deposits (said to amount to £60 million) will have been an offsetting factor, though it is unclear whether the banks did actually pay London rates on all large deposits.²⁹ In the longer run, however, as the balance of payments drained the banks of their high-yielding foreign liquid assets, this advantage will have been running out. The longer the interest differentials persisted, the more the banks' profit margins were being eroded by having to cash-in higher-yielding London investments to finance the expansion of Irish credit.

As mentioned, the 1955 interest rate experiment ended under pressure of circumstances in December, with an increase in the Central Banks' rediscount rate from 3 to 4 per cent, and increases of 0.75 per cent and 0.5 per

24 McEntee's conservatism is underlined by his remarks in the Dáil (10 March 1955): 'One may well ask if the Government's interference in this matter is a step towards the nationalization of the banks or perhaps the *sovietization* of the banks might be a better word'.

25 Exchange control returns indicate that deposits held by foreigners fell by only £0.64 million in 1955. The average decline over the previous four years had been £0.27 million, following inflows of over £2 million in each of 1949 and 1950.

26 Cf. Honohan and Conroy, *Irish Interest Rate Fluctuations*.

27 Cf. P. Honohan, 'Currency Board or Central Bank? Lessons from the Irish Pound's Link with Sterling, 1928-79', *Banca Nazionale del Lavoro Quarterly Review*, No. 200, March 1997.

28 The (commercial) Bank of Ireland's privileged position as the Government's banker made it *primus inter pares*, and underlines the relatively minor role played by the Central Bank.

29 That the agreed interest rate on deposits over £25,000 was increased to 2.5 per cent is clearly stated in Moynihan (*Currency and Central Banking*, p. 421), and confirmed from papers in the files of the Departments of Finance and of the Taoiseach and in the minutes of the IBSC. It is therefore curious to find Meenan (*The Irish Economy*, p. 237) asserting that interest rates on large deposits were held at 1.5 per cent, a figure which is also shown in the table of Appendix 9 in Moynihan (*Currency and Central Banking*). In late March 1955, the IBSC requested the London Clearing Banks not to pay more than 1.5 per cent on large sums transferred from Ireland. It is unclear why such a request would be made if large deposit interest rates in the Republic had actually been increased to 2.5 per cent. It may be that the higher interest rate was not paid uniformly to all large depositors.

cent respectively in the banks' overdraft rate and small deposit rate.

Although the interest rate *démarche* proved unsustainable it was far from being the last time that pressure was placed on the banks to keep interest rates down. The plot of differentials (Figure 4) shows that already these had narrowed before 1955, though 1955 showed the largest fall. But the differentials never fully recovered to their pre-1955 position. For instance, the further one per cent rise in Bank Rate in 1956 was followed by pressure on the banks to differentiate their lending rates as between productive and other loans. This the banks declined to do, but as a result they did not increase their overdraft rate on that occasion.

The degree to which the 1955 episode had a lasting effect in lowering international interest differentials could be exaggerated. Traditionally, Irish differentials had narrowed when London rates were high. During the 1920s and until 1951 (when it was discontinued) the 'Irish banks' rate' was one per cent above London Bank Rate when the latter was below 4.5 per cent; and one-half per cent above London if London was at or above 4.5 per cent. A similar negatively sloped relationship between the differential of the Irish 'ordinary overdraft rate' and London Bank Rate persisted thereafter. A regression of the Irish-UK differential on London Bank Rate 1922-1965 confirms this negative relationship. For example, using the simplest possible equation, one obtains (t-statistics are in parentheses):³⁰

$$\text{Differential} = 4.11 - 0.56 \text{ Bank Rate} \\ (27.5) \quad (72.8) \quad R^2 = 0.969$$

The residuals from this regression are shown in Figure 5. This plot puts the low differentials experienced in 1957 and 1958 in a somewhat different light: the 1955 observation is now more clearly an outlier. The plot also suggests that the differential after 1955 was on average somewhat lower than before.

How did the banks accommodate to the narrower interest differentials? There was some short-term response in their attempt to refinance some of their lending at the Central Bank's low rediscount rate.³¹ But in the longer run two major questions arise: First, to what extent did the banks absorb the lower differential in profits, and to what extent did they pass it on by

30 More sophisticated estimates tell the same basic story. The equation in the text contains residual autocorrelation. Improved statistical properties can be obtained by specifying a somewhat more complicated error-correction formula along the following lines. (Though we omit details of this procedure, including estimates of the order of integration and tests for cointegration). Thus, if $y = \text{Differential} - \alpha \text{ Bank Rate}$, then, allowing α , β , γ to be estimated in $\Delta y - \beta y_{-1} = \gamma$, we obtain: $\alpha = 0.51$ (35.8); $\beta = 0.28$ (4.9); $\gamma = 1.1$ (4.8); $R^2 = 0.859$, $DW = 2.17$. Residuals from this regression also show how much 1955 is an outlier. Extension of this approach suggests that the average differential post-1955 was about 0.29 percentage points lower than before 1955, whereas the 1955 differential was 0.84 points lower than before.

31 Moynihan, *Currency and Central Banking*, p. 425.

tightening criteria for lending spreads above their ordinary overdraft rate? Probably the higher London interest rates in the late 1950s made it easier for the banks to absorb lower spreads. Certainly, the stock-market prices of Irish bank shares did not respond to the policy shift. They drifted downward during 1955 and especially 1956, but less so than British bank prices (Figure 6).³² Indeed, most of the banks (but not the Bank of Ireland) raised their dividends in 1955 or 1956.

Second, how did the banks protect their liquid assets in the face of administered interest rates below London rates? Contemporary sources indicate a willingness to consider rationing of credit as a solution; this could explain why subsequent periods of negative differential did not have the drastic effects of that first one in 1955. Certainly, as early as October 1956, with interest differentials again low, we find Sean Lemass complaining that 'the credit squeeze is being applied to productive enterprises'.³³ The data reveal that credit growth was sharply reduced from 1956 on.

6. Conclusion

With hindsight, the interest rate policy pursued in 1955 appears to have been a policy blunder. The authorities simply failed to observe the implied interest rate discipline of the fixed exchange rate and integrated financial market with Britain. But in the longer run, the crisis of 1955-56 led to a comprehensive and epochal reassessment of economic policy shifting the emphasis to an outward-looking view, ultimately involving a move towards free trade and the promotion of a manufacturing export base especially through the encouragement of inward foreign direct investment.³⁴ Somewhat paradoxically, therefore, the policy failures of 1955-56 may have helped shake economic policy out of the inward-looking complacency into which it had fallen by the mid-1950s.

Monetary activism did not end with the 1955 experiment. Downward pressure on bank interest rates was a constant feature of the following decades, though the authorities learnt to distinguish between the merits of placing pressure on a cartel and the risks of forcing interest rates below corresponding rates in London.

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32 The figure is based on weekly quotations for the Bank of Ireland, Hibernian, and Munster & Leinster banks. A similar pattern is evident from the National and Provincial banks. British bank share prices are summarized by an unweighted average of the prices of Barclays, Westminster and Lloyds.

33 *Irish Times*, 15 October 1956, 'Mr. Lemass calls for general election'.

34 The events surrounding the November 1958 publication of the White Paper *Economic Development* are discussed by Garret FitzGerald *Planning in Ireland* (Dublin, 1968).

Annex 1: Trends in the Volume and Sectoral Distribution of Credit in the 1940s and 50s

In the decade after World War II the Irish banks saw their deposit resources shrink in real terms while demand for credit surged ahead. In part this was a natural unwinding of the position built up during the period of war-time surpluses during which the bank's net holdings of foreign assets reached almost 50 per cent of GNP. It was natural that post-war restocking would result in a fall in the ratio of liquid assets to GNP and an immediate jump in bank credit at home – and indeed 1946–47 saw the largest such movements. This exerted movement on the banks' net foreign assets.

The fall in the liquidity ratio ($M2/$ GNP) began earlier in Ireland than in the UK, but it is important to recognize it as essentially part of the same phenomenon, and indeed one which petered out in Ireland earlier than in the UK (Figure 7). To the extent that the continued rise in UK velocity during the late 1950s and into the 1960s reflects Bordo and Jonung's institutional change hypothesis,³⁵ the failure of Ireland's velocity growth to match that of the UK is suggestive of the lack of dynamism in Irish banking of the period.

Though the growth in bank lending at home from 1945 was not just a bounce-back from wartime constraints, it would be easy to exaggerate the degree to which it signalled a new era in bank behaviour and involvement in the Irish economy. Comprehensive data broken down as between the Irish Free State and elsewhere is available only from 1932 on. At that date, net external assets of the Irish banks amounted to £88 million or 55 per cent of GNP – even higher than the post-war figure. At that date, total domestic lending stood at £58 million, and by 1945 had only crept up to £64 million.³⁶ At this stage, the bulk of lending was to farmers, commerce and personal sector.³⁷ The banks' reliance on the home market for lending had been so limited that, in 1945, only one-third of the resources mobilized by the banks in the Free State were being invested there.

There was a further big surge of credit in 1950–51, associated with stock-piling in connection with the Korean War (Figure 8). This expansion was more rapid in Ireland than by the London clearers, and the subsequent fall-back was also more pronounced in London (Figures 9, 10). By 1954, the

35 Michael D. Bordo and Lars Jonung, 'The Long-Run Behavior of Velocity: The Institutional Approach Revisited', *Journal of Policy Modeling*, xii (1990), pp. 165-97.

36 The decline in net external assets during the 1930s thus reflected more the shrinkage of domestic deposits than an expansion of credit.

37 Between them, these sectors received almost two-thirds of non-Government advances in 1939. Meenan (*Irish Economy*, p. 235-6) reports the bankers' complaints that farmers were substantial depositors, but could not be persuaded to borrow, and reports that farmers deposits came to almost three times their borrowing in 1937. However, it is evident that the remainder of the economy had almost as high a ratio of deposits to borrowings. The bankers' complaint may have reflected their own preference for lending to those who could evidently offer land and stock as security.

Irish banks were investing almost two-thirds of their domestic-sourced resources at home – a considerable departure from earlier experience. Indeed, during the 1950s non-Government bank lending expressed as a share of GNP appears to have been higher in Ireland than in the UK. Previously under-represented sectors, such as mining and manufacturing and schools, churches and charities, began to increase their share at the expense of farmers, commerce and the personal sector, though by the end of 1954 the latter still accounted for some 55 per cent of the total (Figure 11).

The credit surge of 1955 was faster than that of 1950–51. Furthermore, it was much faster than the increase in credit by the London clearing banks, constrained as they were by the policy of credit squeeze in operation there from July 1955 (Figure 10). This time, as mentioned above, mining and manufacturing, and public bodies, got rather more than a proportionate share of the increase, together with the group entitled 'Shipping and ship-building, transport and communications, electricity and gas undertakings'. Retailers lost share.

Credit volumes stagnated between 1955 and 1958. Although there was some pick-up from 1959, it was not as fast as the comparable acceleration in London. In addition, by the end of the 1950s, there was comparatively little change in the sectoral structure of bank lending. Farmers, commerce and the personal sector between them still owed 52 per cent of the total, with the farmers having increased their share. Indeed, if we add the growing 'Schools, charities and churches' sector to these there had been no change over the decade in the share going to this traditional group.

The banks weathered both the pressure on their net external assets, and the interest rate pressures of the 1950s. They remained focused on London for liquidity, and on short-term self-liquidating lending to commerce, farming and the personal and institutional sectors.

Annex 2: Quantifying the turnaround

Two complementary approaches to the analysis of balance of payments disequilibrium are widely employed in the literature, namely the monetary approach to the balance of payments (MABP) and the flow, expenditure components or absorption approach. The first emphasizes stock equilibrium, the second flow relationships.

The MABP begins with the balance sheet identity that the quantity of money equals the sum of the net foreign assets and net domestic assets of the banking system.³⁸

$$M = NFA_{Banks} + NDA_{Banks} \quad (1)$$

In stock equilibrium the demand for money equals the supply.

$$M^d(i) = M \quad (2)$$

Balance of payments flows arise in the process of adjustment from one stock equilibrium to another. In the present context a reduction in the domestic rate of interest offered by the banking system lowers the demand for money and induces an increase in net domestic assets of the banking system seen as a residual. Accordingly, by the balance sheet identity, net foreign assets must decrease. In other words there is a deficit in the balance of payments of non-banks.³⁹

The flow approach seems more informative in the present context, and it underlies Table 1 above. It begins with the flow identity which observes that the current account of the balance of payments must equal the capital account, which in turn equals the sum of the change in the net foreign assets of the bank and nonbank sector:

$$CA = \Delta NFA_{Banks} + \Delta NFA_{Nonbanks} \quad (3)$$

Taking the current account as approximately the difference between exports X and imports P (changes in factor flows are too small to be of significance); modelling imports as a function of consumption C and investment J ; and taking consumption to be a function of personal disposable income Y , we can reorganize this flow identity to read:

$$\Delta NFA_{Banks} = X - P[C(Y), J] + \Delta NFA_{Nonbanks} \quad (4)$$

38 This can alternatively be given as an identity for base money; but in the present context where the behaviour of the private banking system is constrained (interest rate control), the wider identity is more relevant.

39 Projecting each of the elements of this decomposition for 1955 on the basis of a ratio to GDP equal to the average 1953-54 ratio implies that a shortfall in money holdings contributed £17 million to the £50 million turnaround in the net foreign assets of the banking system, with the remainder (£33 million) attributable to excess domestic credit.

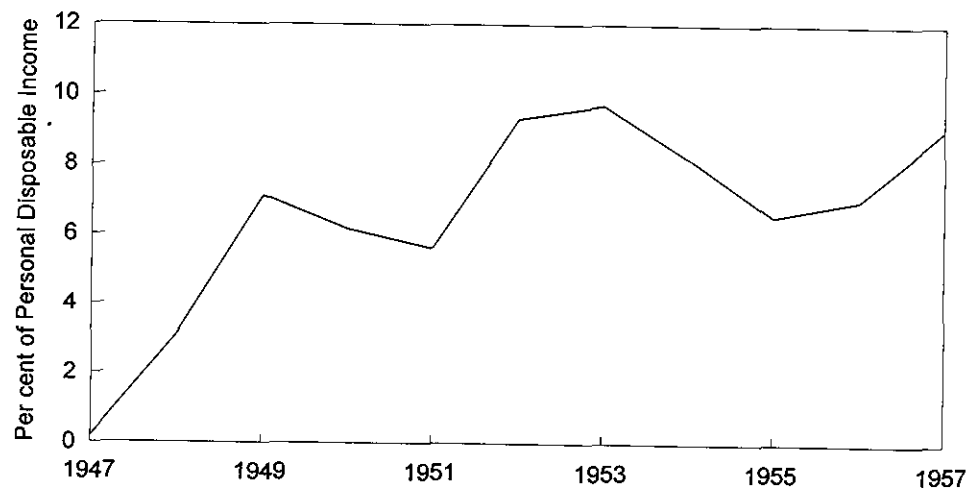
In order to analyze the 1955 deterioration in the net foreign assets of the banking system, we calculated the values which each of the variables in equation (4) would have taken had they retained a constant ratio in GDP. The difference between these hypothetical figures (denoted by asterisks) and the actuals are shown in Table 1A in the text.

For Table 1B, the import excess, i.e. the difference between actual imports P and the hypothetical figure P^* , is further decomposed into the contribution of changes in the saving ratio, in personal disposable income and in investment. Thus, we can express the marginal propensity to import out of personal disposable income as the product of the marginal propensity to import out of consumption Π_C and the marginal propensity to consume out of personal disposable income γ . Writing the marginal propensity to import out of investment is Π_J we obtain the decomposition:

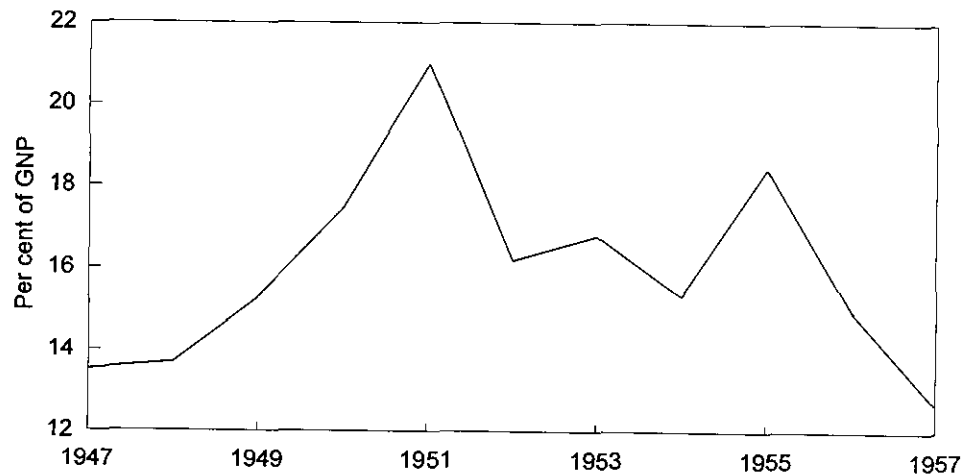
$$P - P^* = \Pi_C [(\gamma - \gamma^*)Y^* + (Y - Y^*)] + \Pi_J (J - J^*) \quad (5)$$

In the Table, the three right hand elements are labelled lower savings ratio, wage increase and investment increase respectively.

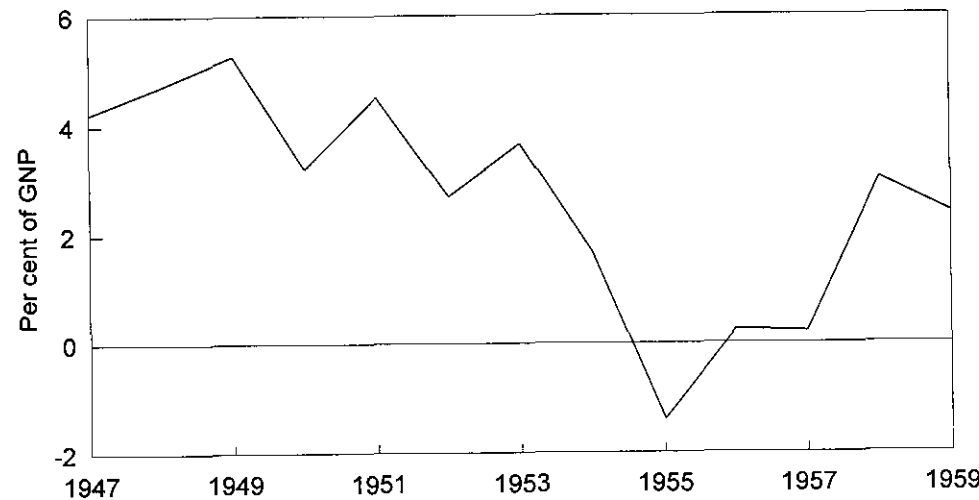
**Figure 1(a): Personal Savings Ratio
1947-57**



**Figure 1(b): Gross Physical Capital
Formation 1947-57**



**Figure 2: Private Non-Bank Capital
Flow 1947-59**



**Figure 3: Irish Bank Profits
1938-54**

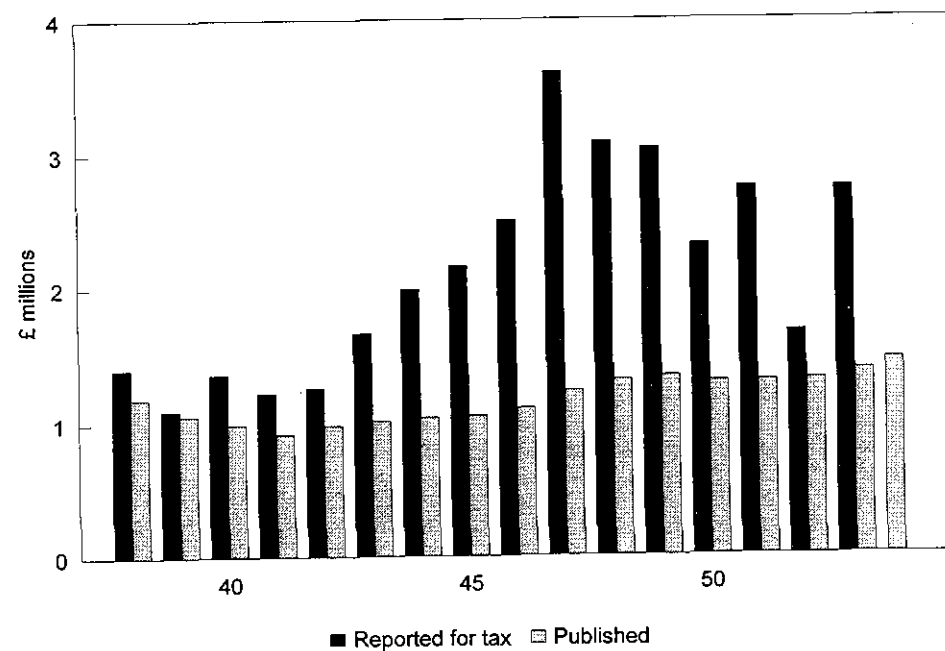


Figure 4: London Bank Rate and Irish Ordinary Overdraft Rate

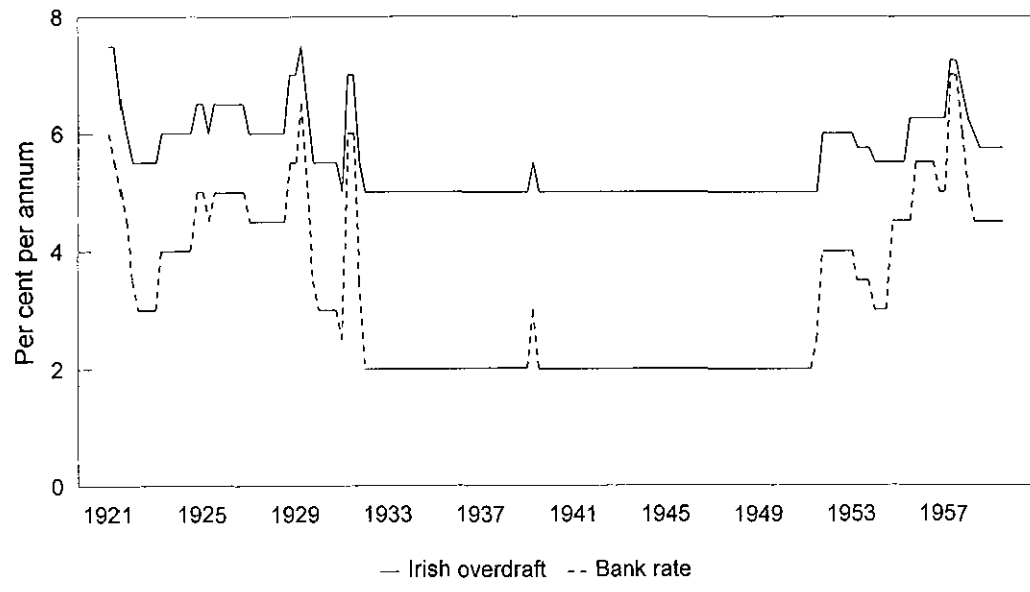


Figure 5: Irish-UK Interest Differential, 1923-1965
Deviation from regression line

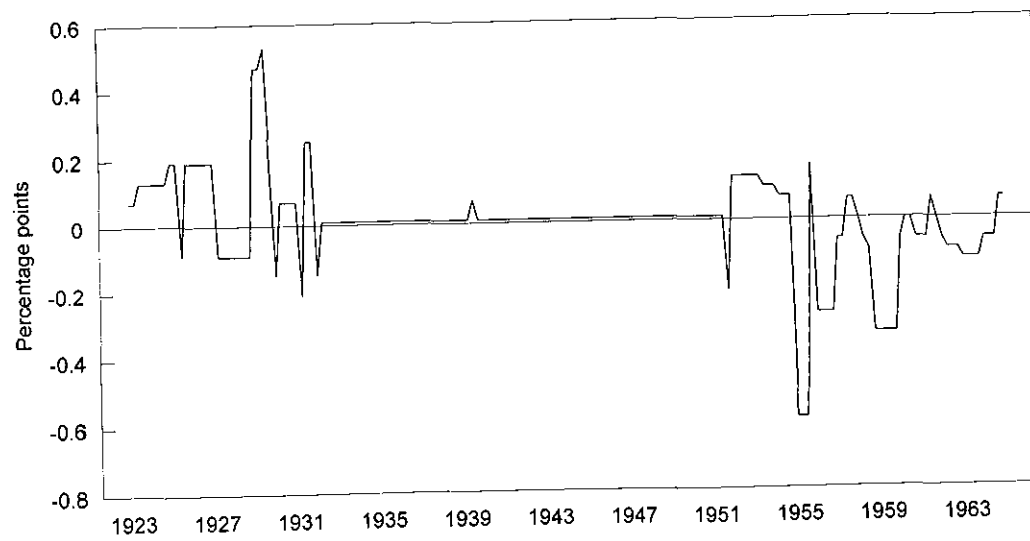
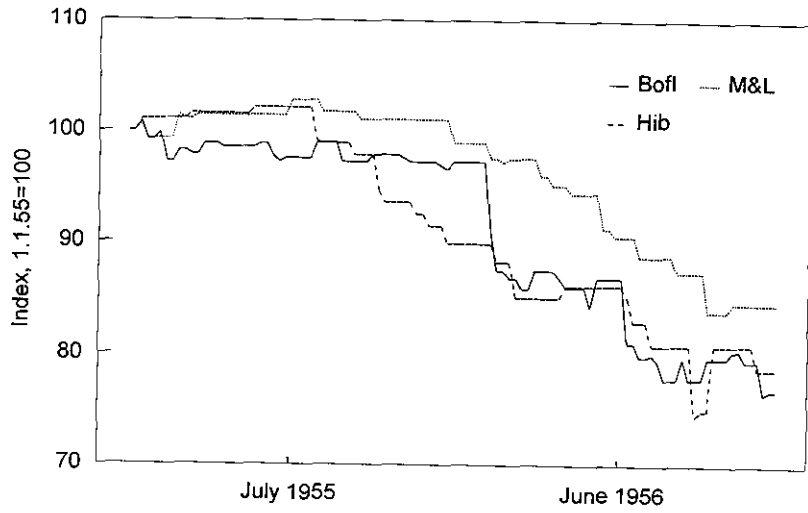


Figure 6: Bank Stock Prices 1955-56
Three large Irish banks



Bank of Ireland relative to UK banks

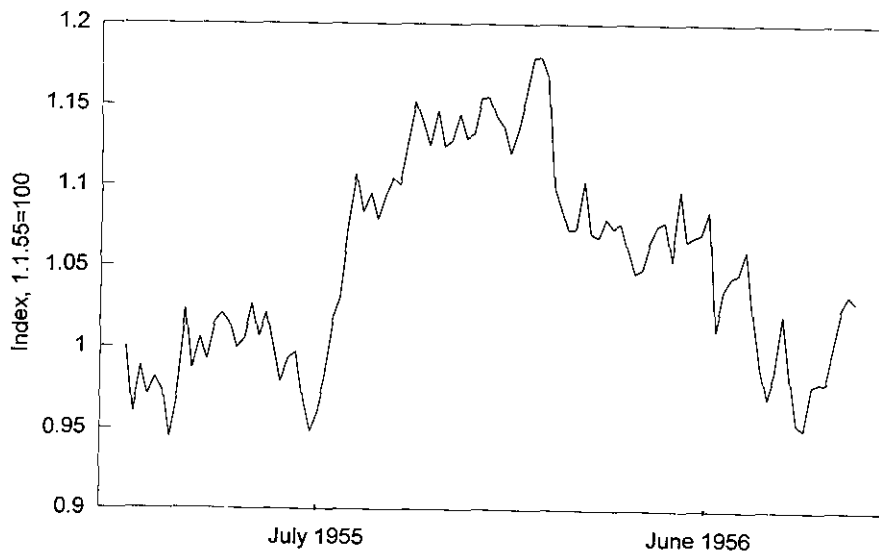
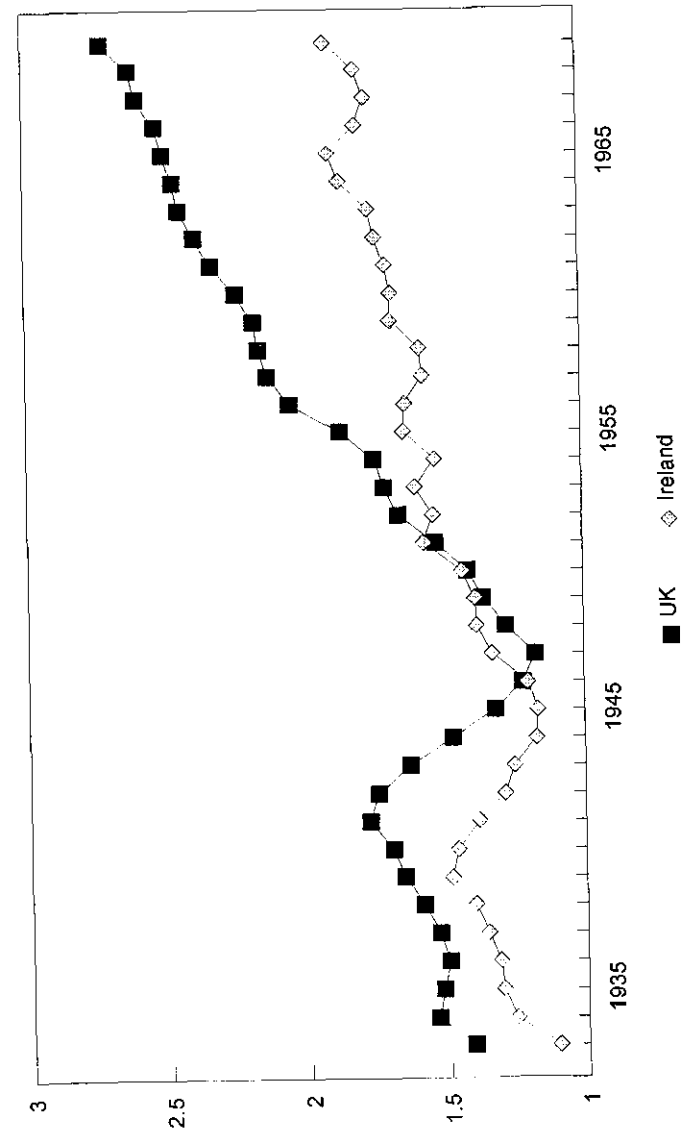


Figure 7: Velocity (M2 or M3)
1933-69



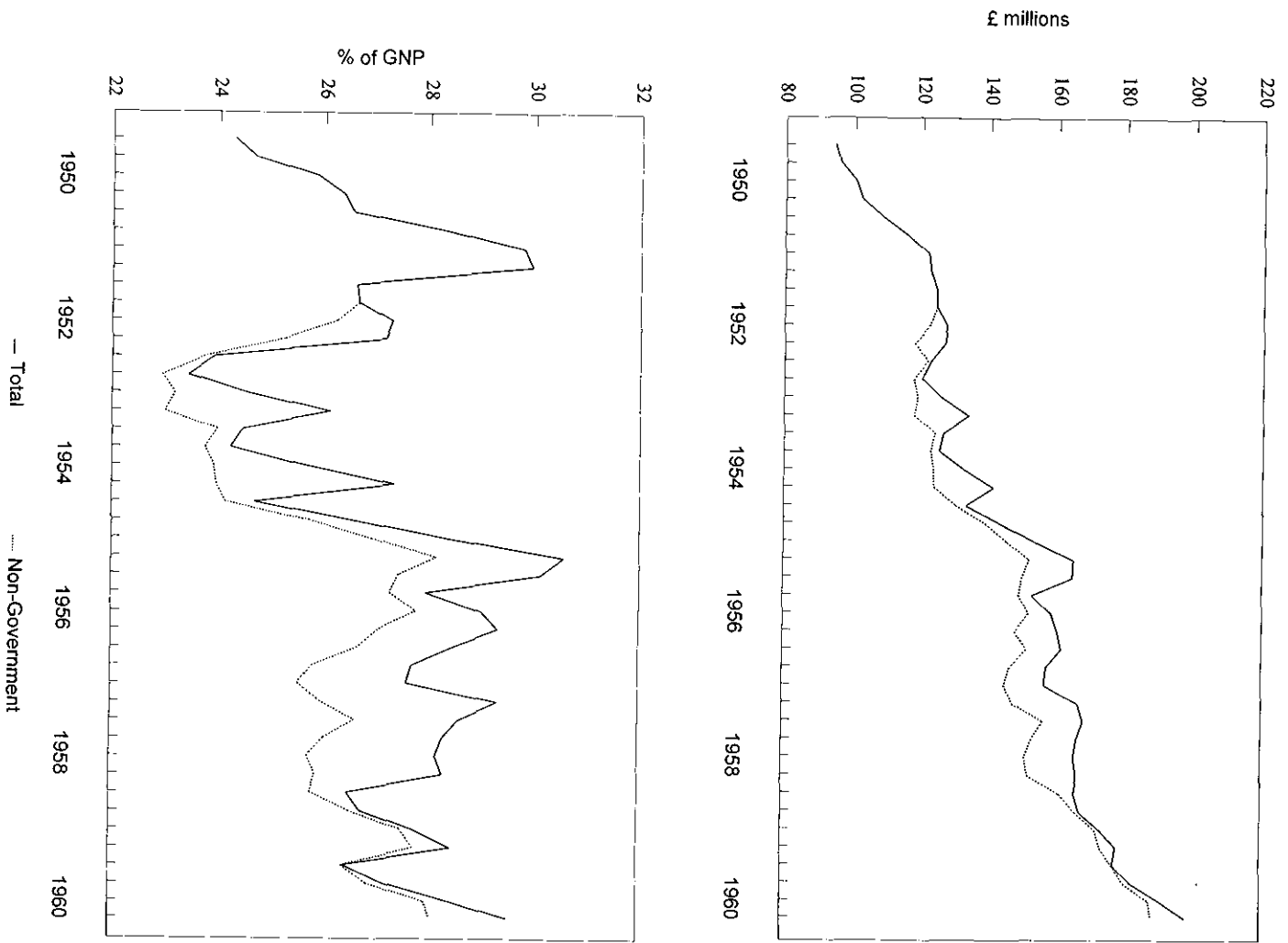
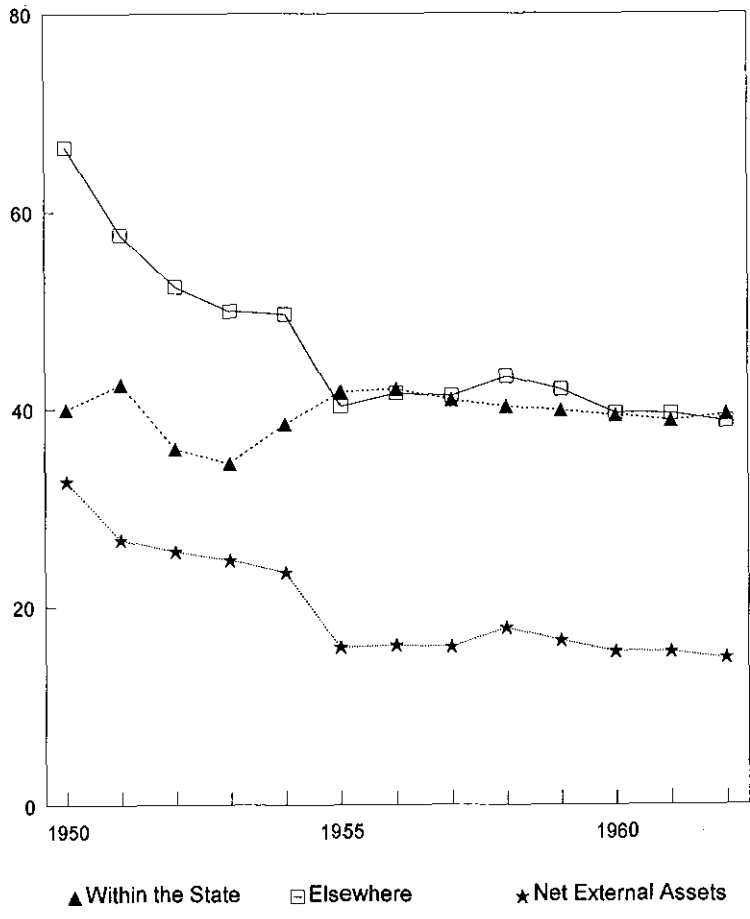


Figure 9: Banks' Assets as %GNP, 1950-62



Banks' Liabilities as %GNP, 1950-62

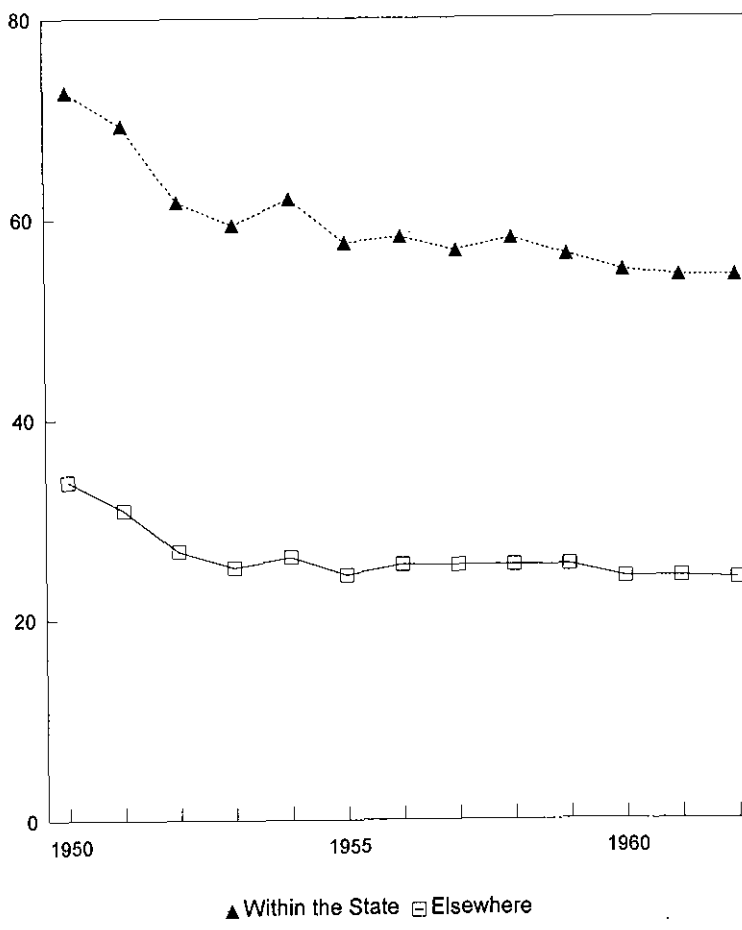


Figure 10: Irish and London Bank Credit, 1950s

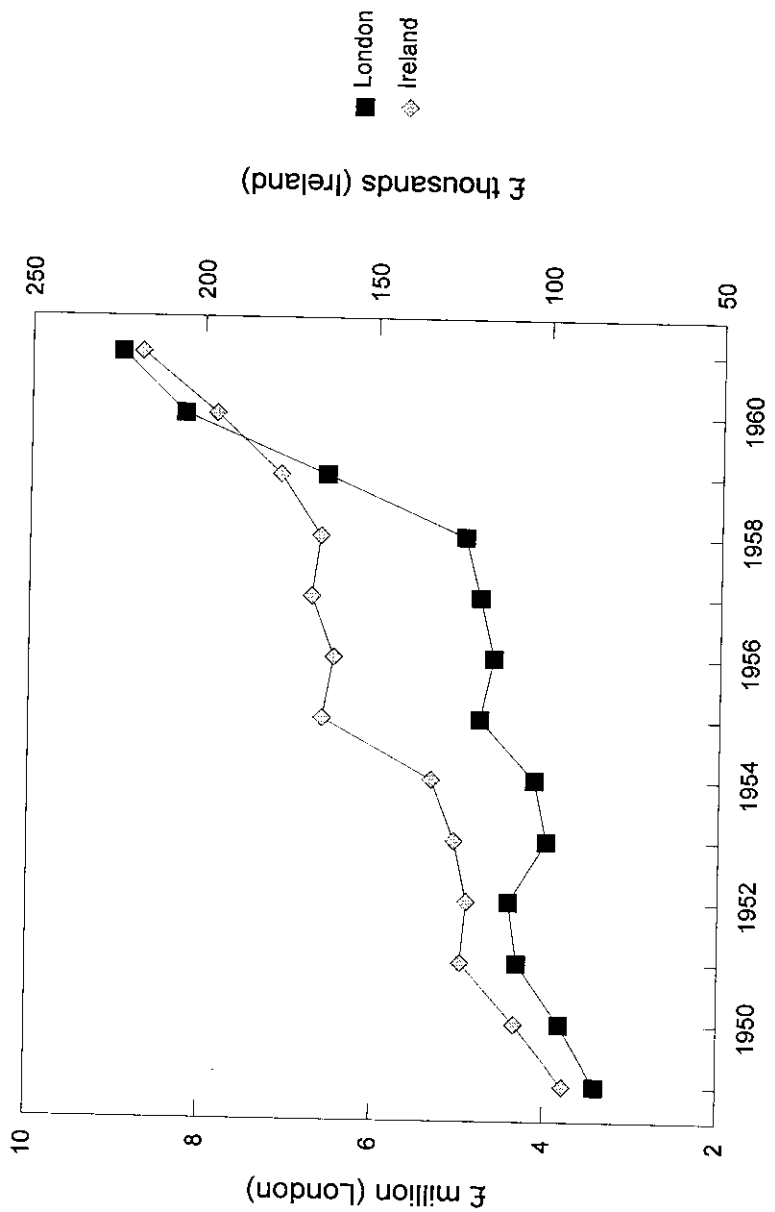
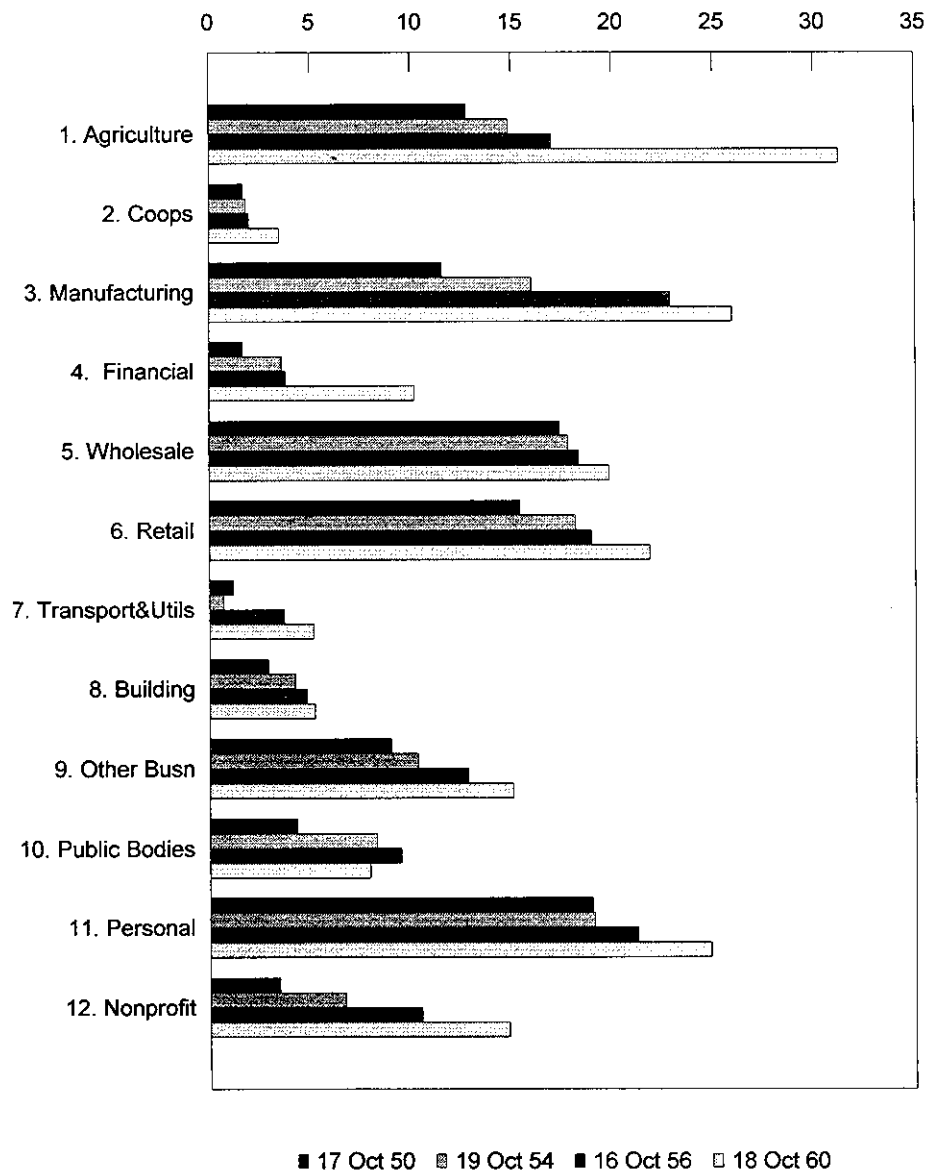


Figure 11: Sectoral Bank Credit, 1950s
£ million



Sector definitions for Figure 11

1. Farmers and Agriculture
2. Co-operative Trading Societies and Creameries
3. Mining and Manufacture
4. Financial, incl. Stockbrokers, etc.
5. Wholesale Merchants
6. Retailers
7. Shipping and Shipbuilding, Transport and Communications, Electricity and Gas Undertakings
8. Builders and General Contractors
9. All Other Business, Ind. and Trade
10. Public Bodies
11. Personal and Professional
12. Schools, Charities, Churches and Hospitals, etc.