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SPRING '99



IRISH BANKING REVIEW

# WHAT'S IN STORE FOR THE CELTIC TIGER?

**Prof. Brendan M. Walsh, Department of Economics,**
**University College Dublin ***

In exploring the medium-term prospects for the Irish economy, this article argues that a pessimistic scenario, in which the rapid growth of recent years inevitably ends in a crash, is not plausible. But neither is it realistic to expect a continuation of "Celtic Tiger" growth rates. Under Irish conditions, GNP growth in excess of 3.5% a year leads to falling unemployment. When "full employment" is reached, further reductions in unemployment lead to rising wage inflation. In the absence of an exchange rate adjustment, high wage inflation leads to a loss of competitiveness. This acts as a break on growth. For these reasons, the realistic medium-term prospect for the Irish economy is that the growth rate will revert to its long-run average in the region of 3.5%.

The growth of the Irish economy during the 1990s has been phenomenal, but there is no consensus about its medium-term prospects. Pessimists suggest that growth rates as high as those recently recorded will lead to a hard landing. Optimists hope that the expansion of the supply side of the economy will facilitate further rapid growth. This article explores some alternative scenarios and offers a view on the likely evolution of the economy.

## THE RECORD

For the last five years the rate of growth of output has been extraordinary both by comparison with the long-run Irish record and by international standards. The phrase "Celtic Tiger" was coined to refer to this performance.

* The author would like to acknowledge helpful comments from Terry Corcoran, Cathal Guiomard, John FitzGerald, Peter Jarrett, Anthony Leddin and John Martin. Responsibility for the views expressed is, of course, the author's alone.

**TABLE 1: ANNUAL AVERAGE GROWTH RATES, (%)**

| | 1994-98 | 1960-93 |
|---|---|---|
| GDP[1] | 8.6 | 3.8 |
| GNP[1] | 7.7 | 3.5 |
| Employment | 4.2 | 0.4 |
| GDP[1] / Employment | 4.2 | 3.2 |
| GNP[1] / Employment | 3.3 | 3.1 |

[1]volume

Table 1 displays the annual average growth rates of output, employment and output per worker over the period 1994-98. For comparative purposes growth rates for the period 1960-93 are also shown.[1]

The rate of growth of GDP since 1993 has been exceptional and that of GNP only slightly less impressive. But the growth of employment has been most spectacular, averaging 4% per year over the period 1994-98. Employment growth at this pace is without parallel in the OECD countries. Indeed, the estimated 6% increase in the numbers at work between 1997 and 1998 is surely a world record.[2] Because employment has been growing so rapidly, the rate of growth of output per worker has been far less spectacular than that of total output. In fact, the annual average growth rates in GNP per person at work before and after 1994 are surprisingly similar. Although the long-run rate of growth of productivity has been satisfactory, it did not increase markedly after 1994. If attention had been focused on output per worker, rather than total output, the phrase “Celtic Tiger” might never have become popular.[3]

The historical decline of the Irish population and chronic high rates of unemployment and emigration have made job creation a national priority. The exceptional growth of employment has therefore been widely welcomed. But we should now question the

[1] It is generally accepted that gross *national* product (GNP) is a better guide to the trend in living standards than gross *domestic* product (GDP). The profits of transnational companies inflate GDP, but are excluded from GNP. An even better measure of the trend in living standards is provided by gross national disposable income (GNDI) which adds current transfers from abroad to GNP, but this is less widely used. More detail on the measurement of Irish economic growth is provided in Leddin and Walsh, 1998, and Honohan, Maître and Conroy, 1998.

[2] The recorded increase was actually 8.3% but some 2% of this is attributed to the change in methodology between the former Labour Force Survey and the new Quarterly National Household Survey.

[3] Productivity may have been growing more rapidly than is implied by the official statistics. Employment in construction, hotels and restaurants, transport, distribution, and financial and business services increased by 17.7% in 1997-98. It is notoriously difficult to measure productivity in these sectors.

importance of the size of the economy, relative to improvements in average living standards, as a goal of economic policy. Recent growth rates have been more than adequate to absorb the growth of the labour force and stabilise unemployment. Women's labour force participation rates have risen to the European average and emigration has been replaced by significant net immigration. It is timely, therefore, to ask what is to be gained from further rapid output growth in itself. We should now focus on raising the living standards of the population rather than trying to maximise the level of employment. At least it would be appropriate to modify the criteria applied in cost/benefit analysis of job creation programmes to reflect the congestion and other external costs associated with growth, as has been suggested recently (Honohan, 1998).

The focus of the rest of this paper is on the future prospects of the economy. It is argued that neither the pessimists, who predict that the current boom must inevitably end in a bust, nor the optimists, who believe that rapid growth can be prolonged more or less indefinitely, are likely to be proved right. The unsurprising conclusion is that a return to a lower growth path is more probable. An estimate of the economy's sustainable growth rate is provided.

## A PESSIMISTIC SCENARIO

Some see hubris in Ireland's current boom and a hard landing as the inevitable consequence. They have in mind a replication of the crashes that countries like South Korea, Indonesia, Thailand and Malaysia experienced in 1997.

This would be a grim prospect. In Indonesia growth averaged almost 8% a year between 1990 and 1996, but fell to 5% in 1997 and to *minus* 14% in 1998. This collapse is shocking primarily because of the vast scale of the human suffering it has brought in its wake (World Bank, 1998), but the suddenness with which it occurred and the lack of warning from the international economics profession are also worrying. In October 1996 the International Monetary Fund (IMF) referred to the "buoyant growth prospects" in Asia (IMF, 1996: 28), while in October 1997 a growth rate of $7\frac{1}{2}$% was forecast for 1998 (IMF, 1997:19).

Some believe a similar fate awaits the Celtic Tiger. They anticipate that a collapse in asset prices – notably residential and commercial property values – will lead to a loss of consumer and investor confidence and to a flight of capital from the country. The trigger might be a cyclical downturn in sectors such as microelectronics, pharmaceuticals, or international financial services. A severe recession would be the inevitable consequence.

It is true that the recent exceptional growth of the Irish economy has been very dependent on the growth of world trade and inflows of foreign direct investment (FDI) motivated by the use of Ireland as an export platform.  Exports grew much faster than output during the 1990s.  It is therefore only realistic to conclude that a contraction of world trade would have a very severe impact on Ireland.  The label pessimist should be reserved for those who believe that the current Irish boom will lead to an Asian-style crash even in the absence of a global recession.  The pessimistic view implies that our nemesis will be “overheating”, a retribution for the exceptional growth that has been achieved.

This scenario may be queried on several counts.  In the first place there is no economic law that says “the faster they grow the harder they fall”.  The evidence does not show that rapid growth, at either the national or regional level, inevitably leads to a bust.[4] True, financial bubbles do recur and they are frequently not recognised until it is too late. In many Asian economies the crash was preceded by bubbles in real estate values.  But the behaviour of Irish house prices – at least until end-1997 – can be accounted for by fundamental factors such as the growth of the number of households, the rise in disposable income and falling interest rates (Bacon *et al.,* 1998).  A slump in house prices is unlikely to trigger a recession in the way that the collapse in speculative real estate booms preceded the Asian crises.  In those countries real estate speculation was fuelled by inflows of capital attracted by high interest rates and corrupt banking systems led to massive misallocation of resources.  In Ireland FDI has been the main type of capital inflow and this is much less destabilising than portfolio investment (IMF, 1998).

The collapse of the residential property market in England in the early 1990s was caused by a unique combination of factors.  These included the removal and re-imposition of domestic rates and major changes in the tax treatment of mortgage interest.  It is true that the recent convergence of Irish interest rates on euro-zone rates is an unwelcome pro-cyclical influence on house prices.  The removal of the Residential Property Tax was also inappropriately pro-cyclical and has precluded the use of property taxes as a way of calming the housing market.  But, despite these considerations, the parallels with the situation leading up to the English housing bust are not close.

Most of the Asian countries that crashed had pegged their currencies to the US dollar during the1990s.  This was beneficial as long it helped to control inflation without undermining competitiveness.  But between mid-1995 and mid-1997 the dollar/yen exchange rate rose from 85 to 125.  East Asian currencies were dragged up by the appreciating dollar and their current accounts moved into deficit.  For a while these

[4] For a trenchant refutation of this notion see Krugman (1998).

deficits were readily financed by capital inflows, attracted by high interest rates and the apparent absence of exchange rate risk. But as the precariousness of the situation became evident, speculators attacked the vulnerable currencies. Despite official assurances that parities would be defended, the Korean won, the Malaysian ringgit, the Indonesian rupiah and the Thai baht were all devalued in the course of 1997. When some semblance of normality returned to markets early in 1998, the Indonesian rupiah had lost three quarters of its previous value in terms of the dollar. Many other East Asian currencies also depreciated by large amounts.

On this score, too, the parallel between Ireland's present situation and that of the Asian economies is not close. There is a sizeable surplus on the Irish current account. The Irish pound did not become sharply overvalued in its dying days. Instead, thanks to the widening of the ERM bands in 1993 we were able to avoid the real appreciation that sterling underwent as it rose from DM2.30 to over DM3.00 in 1996-97. The euro conversion rate of the Irish pound and the recent fall in the euro have placed the economy in a very competitive position. Those opposed to Ireland's entry to Economic and Monetary Union (EMU) warn of the economy's vulnerability in the event of a sudden sharp depreciation of sterling relative to the euro. Several sectors of the Irish economy would be adversely affected if this happened. But while foreign exchange markets will retain their capacity to surprise, the probability is small that the sterling/euro exchange rate will fluctuate as widely as the dollar/yen rate.

A final consideration relates to the sources of Ireland's rapid growth. Although the crisis in Asia was not widely anticipated by economists, attention had been drawn to structural weaknesses (Young, 1992; Krugman 1994). It was pointed out that the spectacular growth of the "Asian Tigers" was not "miraculous" but mainly a reflection of rapid growth of capital and labour inputs. The growth of output per unit of capital and labour inputs (Total Factor Productivity (TFP)) was not spectacular. The importance of this point lies in the fact that, in the long run, improvements in living standards depend primarily on the growth in the efficiency with which inputs are used.

The Irish record on this score provides further reassurance. We have achieved a creditable long-run rate of productivity growth.[5] Recent studies estimate that TFP increased by 4% a year between 1987 and 1997 (Kenny, 1996; Nugent, 1998). This compares with a TFP growth rate of only 2% over the period 1975-90 in Singapore, for example (Sarel, 1996). It is important, however, to bear in mind that our productivity growth reflects the impact of the inflow of FDI and the decline of low productivity employment in agriculture, distribution and the public sector. The contribution of these factors to productivity growth will decline in the future.

[5] But it is true, as pointed out above, that there was no dramatic increase in this growth rate during the "Celtic Tiger"period.

In summary, while the risks of speculative bubbles and resource misallocation are not absent from the Irish economy, the situation is not very similar to that prevailing in the Asian economies before the crash of 1997. A scenario in which the Irish boom ends in a homegrown bust is not very plausible. But that does not imply that the good times will roll on forever. A global recession would lead to a hard landing, but it is more likely that the boom will run out of steam due to the operation of basic economic constraints. These are discussed below.

## AN OPTIMISTIC SCENARIO

At the other end of the spectrum from those who expect the current boom to be followed by a crash are optimists who see no reason why Ireland's exceptional growth should not continue long into the future. The rosy scenario envisaged by these commentators is based on a belief that several favourable trends can be maintained. These include:

- rapid labour force growth;
- rapid productivity growth;
- wage moderation.

In addition, it is believed that existing infrastructure and housing deficits can be rapidly eliminated. However, each of these assumptions is questionable.

The supply of labour is no longer as elastic as it was in the 1990s. The rapid growth of the labour force over the past decade was due to non-repeatable factors such as the sharp rise in women's labour force participation rates and the arrival on the labour market of the baby boom of the late 1970s. Further increases in women's labour force participation rates will only be elicited by higher rates of pay to compensate for rising work-related costs – childcare and transportation, for example. The reversal of net emigration was also important, but as the supply of returning emigrants dries up, the rate of immigration will be increasingly constrained by housing shortages and by restrictive policies towards non-EU citizens. The contrast with some regions of the US, where rapid growth is facilitated by a virtually free flow of low-wage labour from Latin America and further afield, is striking. For this reason, and because of the inadequacy of our infrastructure, the parallel between the booming Irish economy and regions of the US is not as close as might appear (Krugman, 1997).

The growth of productivity will be checked by the fact that the recent "shake out" of the labour force cannot be continued. The decline of low-productivity employment will be proportionately less important in the future. Irish manufacturing has been transformed by the inflow of high-tech FDI and additional projects will have a reduced impact on average productivity. Employment in service sectors is growing in importance and productivity gains are generally much smaller here than in manufacturing.

The prospects for continued wage moderation should be linked to the impact of rapid growth on unemployment and the labour market. This topic is discussed below.

Finally, optimism about the prospects of rapidly overcoming our infrastructure deficits is not warranted. The binding constraint is not financial. The public finances could accommodate significant increases in capital spending and there is also ample scope for public-private financial partnerships. The bottlenecks are in the planning, implementation and management of large projects, as well as in the emerging labour shortages in the construction sector. It may be decades rather than years before the existing backlogs in urban and industrial infrastructure housing and the national transport network are removed.

For these reasons, it is implausible to argue that the Irish economy can maintain the high output growth rates that have been recorded since the mid-1990s. There is no evidence of a sea change on the supply side of the economy to justify this optimism. In fact, all the evidence suggests that we are now approaching the point where the constraints on growth will become increasingly binding. We must now examine these constraints explicitly.

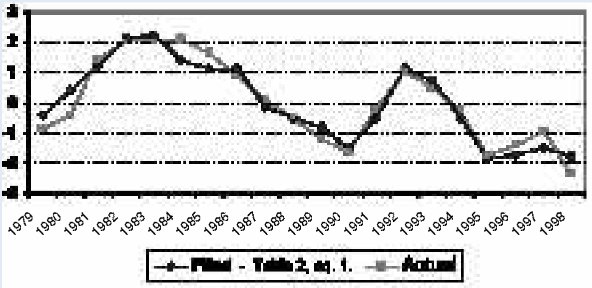
## LIMITS TO GROWTH

A realistic assessment of the medium-term prospects for the Irish economy should eschew the pessimistic and optimistic scenarios outlined above. Instead, guidance should be found in tried and tested economic “laws”. Two robust generalisations are relevant. The first is “Okun’s Law” and the second the Phillips Curve.

Okun’s Law has been described as a “truly sturdy empirical regularity…that closes the loop between real output growth and changes in unemployment with stunning regularity” (Blinder, 1997: 241). Research has documented its value in an Irish context and shown that a GNP growth rate much in excess of 3.5% triggers a decline in unemployment (Leddin and Walsh, 1998). The **Appendix** to this article contains updated estimates of the link between changes in unemployment and output growth. The influence of UK unemployment on the dynamics of Irish unemployment is also taken into account. The results confirm that when the growth rate of GNP exceeds 3.6%, or that of GDP exceeds 4.4%, unemployment tends to fall.

Figure 1 shows how closely the Okun relationship tracks the behaviour of Irish unemployment since 1979. For every percentage point by which GNP growth exceeds 3.5%, the unemployment rate falls by a little over one quarter of a percentage point (given the level of UK unemployment). There is no evidence that this relationship changed during the "Celtic Tiger" years. It follows that two more years' GNP growth at 7% would reduce unemployment from its present level of under 7% to under 5%. Three years' growth at 6% would have much the same effect.

**FIGURE1:CHANGEINUNEMPLOYMENTRATE: 1979–98**
**ACTUALANDFITTED VALUES**




This raises the question: What unemployment rate represents "full employment"under Irish conditions? This question is better restated as: At what rate of unemployment does overheating of the labour market become manifest through rising wage inflation?

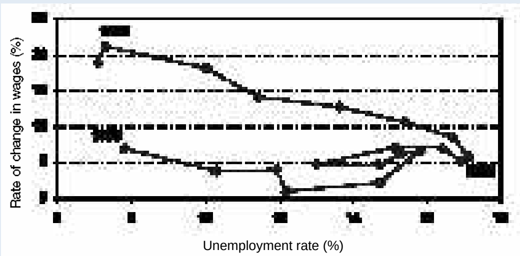
The second of our basic macroeconomic "laws", the Phillips Curve, is relevant to answering this question. The Phillips Curve depicts the association between unemployment and inflation. Originally this association was based on the historical evidence that in Britain wages rose faster when unemployment was low. This was generalised into a belief in a trade-off between inflation and unemployment.Although this relationship has been much refined over the years, it is still generally accepted that falling unemployment leads to higher inflation. Full employment is defined as the unemployment rate below which the rate of inflation tends to rise.[6]

[6] In Ireland the rate of price inflation is largely externally determined and the effect of unemployment is on wage inflation.

It may be argued that in Ireland the link between wage inflation and unemployment has been suspended by the Partnership approach to wage bargaining. Many commentators claim that, since the late 1980s, centralised wage bargaining between unions, employers, and government ("Corporatism") has delivered moderate nominal wage increases and preserved the economy's competitive position in the face of declining unemployment.[7] According to this view, we are in a virtuous cycle. Wage moderation has facilitated rapid employment growth. The resulting tax buoyancy has permitted cuts in income tax rates that reinforce wage moderation and allow real take-home pay to rise faster than employers' labour costs. In recent years, cuts in income taxes have bestowed increases of 2% to 3% a year in workers' after-tax incomes over and above increases in pre-tax wage rates. Optimists see this sequence of events continuing and moderating, if not entirely averting, the traditional trade-off between falling unemployment and rising wage inflation. A more pessimistic view is that the contribution of tax cuts cannot be large enough to maintain equilibrium in the labour market if unemployment continues to fall.

At first sight the evidence from the last ten years seems to support the optimistic view. Over the period 1980-89, falling wage inflation was associated with rising unemployment and the economy traced out a conventional downward-sloping Phillips curve (*Figure 2*). But between the end of the 1980s, when centralised wage bargaining was reintroduced, and the mid-1990s unemployment fell and wage inflation remained low. Inflationary expectations declined and the Phillips Curve shifted leftward, markedly improving the inflation/unemployment trade-off.

**FIGURE2: THE IRISH PHILLIPS CURVE**




[7] It is, of course, possible that the return to Corporatism was due to the severity of the unemployment crisis of the late 1980s.

It is plausible to claim that during these years the Corporatist approach to wage bargaining delivered gains in employment and reduced unemployment. But it should be borne in mind that other factors – including the global collapse of inflation and the appalling level to which Irish unemployment climbed – played crucial roles in lowering inflation expectations. The most recent evidence[8] shows that, with unemployment at an historically low level, wage inflation is rising markedly. This suggests that the Phillips Curve has been dormant, not dead. Now that several years of exceptional growth have mopped up the surplus labour supply and shortages are becoming widespread in the labour market, the traditional unemployment/inflation trade-off is re-emerging. If rapid output growth is maintained and unemployment continues to fall as predicted by Okun's Law, competition for the available supply of labour will lead to higher wage inflation regardless of the system of wage bargaining that is put in place.

This does not imply that the economy will revert to the situation that prevailed in the 1980s, when an unemployment rate of 7% was associated with wage inflation of over 20%. Price inflation expectations are now very low and a given rate of nominal wage increase represents a much higher expected increase in real wages than was the case twenty years ago. But we have moved beyond the horizontal segment of the Phillips Curve to the point where further reductions in unemployment will generate higher wage inflation. Increased supplies of labour – from higher immigration and labour force participation rates – are only likely to materialise as wage rates rise.

In summary, the basic constraint on Irish growth is the following well-documented sequence of events. Rapid output growth reduces the unemployment rate. After a certain point, falling unemployment generates higher wage inflation. Irish wage inflation exceeds that in other euro-zone countries and the economy's competitiveness is eroded. The growth rate falls back to the rate that is consistent with stable unemployment. This appears to be in the region of 3.5%.

## CONCLUSIONS

This article compares the period of the "Celtic Tiger" with the longer-run record of the Irish economy. Attention is drawn to the fact that the most striking aspect of the current boom is the rapid growth of employment. The rate of growth of *output per employed person* has been much less impressive. Because long-run gains in living standards depend on the rate of growth of productivity, it is argued that the rate of growth of output should not be regarded as an end in itself and more attention should be paid to the growth rate of output per worker.

[8] The wage data for 1998 are estimated on the basis of the indicators available at end-1998.

Alternative medium-term scenarios for the Irish economy are assessed. It is suggested that neither a super-optimistic scenario, with output continuing its recent very rapid growth, nor a pessimistic one, in which the Irish boom inevitably crashes in a hard landing, is realistic. Instead, it is more likely that the current rapid growth will be checked by well-established mechanisms. These are the links between rapid output growth and falling unemployment and between falling unemployment and rising wage inflation.

The historical evidence suggests that GNP growth in excess of 3.5% leads to falling unemployment under Irish conditions. There are no grounds for believing that this relationship changed in the course of the current economic boom. Continued rapid growth will reduce unemployment further and lower unemployment will generate higher wage inflation. There is growing evidence that this process is already underway. The Partnership approach to wage bargaining is unlikely to halt it.

Rising wage levels and a deteriorating competitive position will slow the economy's growth to a sustainable rate. The historical evidence suggests that a GNP growth rate in the range 3.5%-4% is consistent with a stable unemployment rate. This is the most plausible medium-term prospect for the economy.

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## APPENDIX

### Okun's Law: The Evidence for Ireland

Formally Okun's Law may be stated as follows:

$\Delta u = \alpha_0 + \alpha_1 g_y$

The rate of growth of output that stabilises the unemployment rate is $g_y^* = \alpha_0/-\alpha_1$.

The coefficient $\alpha_1$ is expected to be less than unity because the relationship between the rate of growth of output and changes in the unemployment rate is not one-to-one. Improvements in productivity allow additional output to be obtained from the same labour force. Some employment growth is required simply to absorb the growth of the labour force. And the rate of growth of the labour force varies due to changes in labour force participation and migration rates. This factor is very important in Ireland and would be expected to weaken the link between output growth and changes in unemployment. In fact it has been argued that Irish unemployment can be satisfactorily explained by the behaviour of UK unemployment alone (Honohan, 1992). However, the gap between Irish and British unemployment rates has not been constant and the growth of the economy affects the unemployment rate (Walsh, 1998).

To take account of the influence of the British labour market on Irish unemployment the change in British unemployment can be added to the basic Okun relationship:

$\Delta u = \alpha_0 + \alpha_1 g_y + \alpha_2 \Delta u_{UK}$

Allowance may also be made for lags in the impact of changes in output on unemployment by including the lagged rate of change in output, $g_{y\,t-1}$ and a lagged term in the change in UK unemployment, $\Delta u_{UK\,t-1}$.

Table 2 displays the results of estimating the relationship for the periods 1961-98 and 1979-98.[1] By conventional statistical criteria the results are very satisfactory. The high $\overline{R}^2$ indicates that much of the year-to-year variation in the Irish unemployment rate is explained by the model. The fit is closer when GNP, rather than GDP, is used as the output measure – perhaps reflecting the distorting effect of transfer pricing on the latter. Current and lagged output growth rates have a very significant effect on the unemployment rate. This association was closer after 1979 than over the longer time

[1] Some points about the data should be noted. First, there are arguments for using either GNP or GDP as the output measure, so results are presented for both. The published April unemployment series has been adjusted to a January basis so that the timing of the change in unemployment, $\Delta u$, corresponds with the annual growth rate of output, $g_y$.

period. An intercept dummy variable for the “Celtic Tiger”period was not significant. The lagged change in UK unemployment is also significant and suggests that, other things being equal, a rise of one percentage point in UK unemployment would raise Irish unemployment by somewhat less than 0.5 of a percentage point. The estimates of the threshold growth rate, $g_y$*, are very stable.

**TABLE 2: ESTIMATES OF OKUN'S LAW, IRELAND**

**(t-ratios in parentheses)**

$$\Delta u_t = \alpha_0 + \alpha_1 g_{y\,t} + \alpha_2 g_{y\,t-1} + \alpha_3 \Delta u_{uk\,t} + \alpha_4 \Delta u_{uk\,t-1}$$

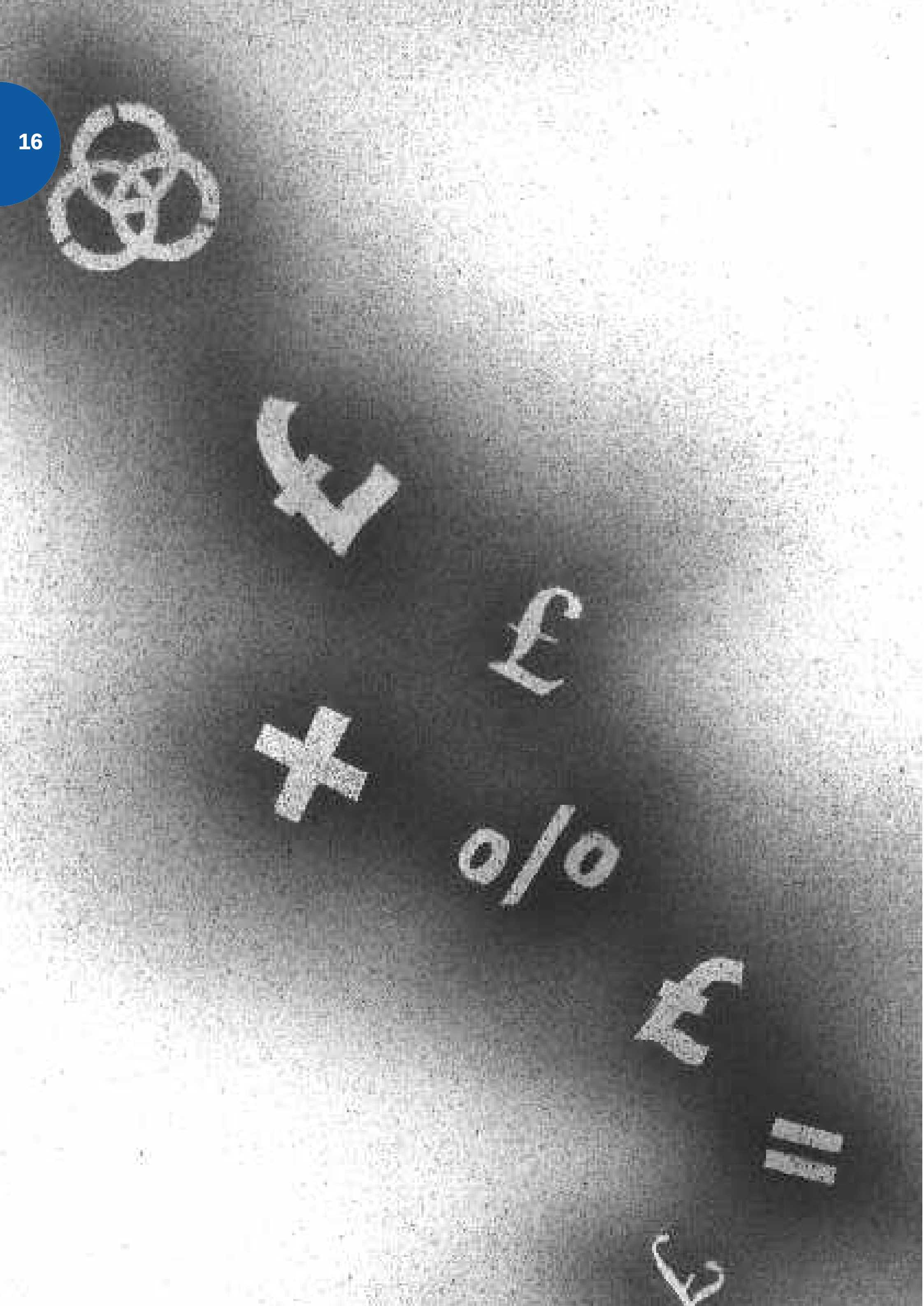
| Equation No. | $\alpha_0$ | $\alpha_1$ | $\alpha_2$ | $\alpha_3$ | $\alpha_4$ | Estimate of $g_y$* | $\bar{R}^2$ | D.W. |
|---|---|---|---|---|---|---|---|---|
| | | | | ***y* = GNP** | | | | |
| | | | | **Period: 1979-98** | | | | |
| **1** | 1.21<br>(5.9) | –0.16<br>(3.5) | –0.18<br>(4.5) | 0.12<br>(1.2) | 0.26<br>(2.1) | 3.6 | 0.90 | 1.7 |
| | | | | **Period: 1961-98** | | | | |
| **2** | 1.05<br>(6.6) | –0.13<br>(4.0) | –0.15<br>(4.6) | 0.12<br>(1.4) | 0.40<br>(4.6) | 3.8 | 0.86 | 1.4 |
| | | | | ***y* = GDP** | | | | |
| | | | | **Period: 1979-98** | | | | |
| **3** | 1.41<br>(4.1) | –0.13<br>(2.1) | –0.19<br>(3.1) | 0.08<br>(0.6) | 0.37<br>(2.3) | 4.4 | 0.82 | 1.2 |
| | | | | **Period: 1961-98** | | | | |
| **4** | 1.14<br>(5.2) | –0.12<br>(3.0) | –0.14<br>(3.4) | 0.10<br>(0.9) | 0.47<br>(4.5) | 4.4 | 0.80 | 1.2 |

**Notes:**

i. $g_y$* is the rate of growth of output at which the Irish unemployment rate stabilises for a given level of UK unemployment.

ii. When an error correction term was added to equation 1 its coefficient was very small (–0.05) and non-significant (t-ratio = 0.9).

iii. $g_y$. is not exogenous . Changes in unemployment affect the growth of output, as well as vice versa. Allowing for simultaneity does not materially alter the estimates of $g_y$*.



# WHAT INSTITUTIONAL STRUCTURE OF FINANCIAL REGULATION IS APPROPRIATE FOR IRELAND?

**Prof. David T. Llewellyn, Professor of Money and Banking, Loughborough University, UK ***

Arising from the Government's decision to reform the financial regulatory system, this article considers some of the issues involved in reorganising the institutional structure of financial regulation. In particular, the focus is on three issues:

- whether a single agency should be created;
- whether the Central Bank should be responsible for banking supervision; and
- the implications of monetary union in Europe for the role of national central banks and the lender-of-last-resort role.

The objective is to offer a balanced overview of the key issues, not to advocate any particular model.

## INTRODUCTION

The question of institutional structure of regulation has become a major issue of policy and public debate in several countries; it is not unique to Ireland. Increasing emphasis is being given to the general question of whether the efficiency of regulation and supervision in achieving their objectives may be influenced by the particular institutional structure in which they operate.

One of the first policy initiatives of the new UK Labour Government, elected in May 1997, was to undertake a total reorganisation of the institutional structure of financial regulation. This was done by sweeping away specialist agencies and vesting all regulation, including banking supervision, in a single agency[1]. In Australia, issues related to institutional structure were very much on the agenda of the Wallis Committee (1996), which also recommended major changes. The main recommendation was not

* Prof. Llewellyn is also a Public Interest Director of the Personal Investment Authority and has served as a consultant to regulatory authorities in several countries. He writes here in a personal capacity. Together with Charles Goodhart and others, he is the author of the monograph, *Financial Regulation: Why, How and Where Now?*, which was commissioned by the Bank of England for the 1997 Central Bank Governors' Symposium in London.

[1] See Hartman, 1997 and SIB, 1997.

for a single agency but for the “twin peaks” model which is discussed later. Institutional structure is also being actively considered in South Africa, where changes are envisaged following a series of official reports and discussion papers. Similar issues are being discussed in many other countries.

While the debate in each country inevitably reflects country-specific factors and the institutional structure that currently prevails, there are more general reasons why the debate has recently emerged and some of the traditional assumptions about institutional structure have come to be challenged.

- In many countries the structure of regulatory agencies was devised for a different structure of the financial system than now exists. Financial innovation and structural change in the financial system have challenged many of the assumptions made at the time current structures were created. This raises the issue of whether institutional structure should mirror the evolution of the structure of the financial system and the business of regulated firms.
- The emergence of financial conglomerates has challenged traditional demarcations between regulatory agencies and has made the business of regulation more complex. In particular, the issue arises as to whether a structure based on specialist agencies supervising different parts of the business of a financial conglomerate may lose sight of the institution as a whole.
- Over time, changes in institutional structure have often been made as a response to particular financial failures, and a pragmatic, piece-meal structure has emerged which would not necessarily be created from scratch and without the legacy of existing institutions. From time to time it is appropriate to review what has emerged and to consider whether a more coherent structure can be put in place.
- In many countries the objectives of regulation have become more complex and extensive. For instance, conduct of business issues have become more significant. This is most notably the case in the UK where several agencies have been responsible for the conduct of different types of financial business and institutions. This raises the issue of whether an excessive number of institutions unnecessarily adds to complexity, uncertainty and to the costs of regulation. This was clearly the view taken in 1997 by the incoming Labour Government in the UK.
- Financial innovation, and the emergence of new financial markets, has made the risk characteristics of financial firms and the financial system generally more complex. In particular, the systemic dimension to regulation and supervision may no longer be exclusively focused on banking. Banks have lost some of their uniqueness which has traditionally been a case for supervision by the Central Bank.

- The increasing internationalisation of financial operations has accentuated the international dimension to regulation that, in turn, has implications for the institutional structure of agencies both at the national and international level.
- Public perceptions and credibility may also be a significant issue in that, with multiple agencies, it may not be clear to the consumer which agency is responsible for which particular issues of regulation, or to whom complaints are to be addressed.

## SOME KEY ISSUES

There are several issues to be considered before embarking on any reform of the institutional structure of financial regulation.

(i) The first of these is the appropriate number of regulatory agencies. Should there be a series of specialist regulators or a single, all-embracing agency?

(ii) What structure of agencies is most appropriate, which functions and firms are to be allocated to which agencies and how are the objectives for each agency to be defined? In particular, the issue arises as to how *functional* and *institutional* dimensions to regulation are to be allocated as between different agencies.

(iii) What degree of co-ordination should there be between different agencies and what mechanisms are needed to ensure efficient and effective co-ordination, co-operation and information sharing?

(iv) How significant a bearing, if any, does institutional structure have on the costs of regulation?

(v) In so far as regulation has consequences for competition, what is the role, if any, of competition authorities in the regulatory process?

(vi) What role, if any, is to be given to self-regulation and mechanisms for practitioner input?

(vii) Given the international dimension to regulation, what institutional mechanisms are most efficient at facilitating international co-ordination and co-operation between national regulatory agencies?

(viii) Given the power that regulatory agencies have, how best can their independence and accountability be facilitated?

## NO SINGLE MODEL

A review of international experience indicates a wide variety of institutional structures for financial regulation.[2] Some countries (e.g.Sweden, Canada, Denmark) have reduced

[2] See Goodhart, *et al*., 1998.

the number of regulatory agencies and in some cases created a single *mega* agency. This same process is now underway in the UK. Other countries have opted for multiple agencies and in some cases have increased the number. Differences reflect a multitude of factors:historical evolution, the structure of the financial system, political structures and traditions and the size of the country and financial sector. With respect to the last mentioned, for instance, if there are economies of scale in regulation, a single agency might be especially appropriate for small countries.

All of this suggests that there is no obvious 'ideal model' in existence which could be universally applied. It would also appear that there are problems associated with each of the different structures currently in place in different countries. It might, therefore, be necessary to accept the inevitability of something of an imperfect set of institutional arrangements.

The crucial point in the debate is to emphasise that institutional structure does not in itself guarantee what really matters: namely, the effectiveness of regulation in achieving its objects in an efficient and cost-effective manner. In its published Regulatory Plans, the Personal Investment Authority in the UK has made a distinction between effectiveness, efficiency and economy in the assessment of regulation (see, for instance, Personal Investment Authority, 1997).

## ALTERNA TIVE FRAMEWORKS

There are broadly three ways of categorising regulatory arrangements: these are by *institution,* by *function* or by *objectives.* Thus different institutions may be regulated differently and by different regulatory agencies. Alternatively, different functions may be regulated differently and by different agencies irrespective of which institutions are performing those functions. There are hazards in each of these alternatives. In the case of institutions, the danger is that different regulatory agencies may apply a different type and intensity of regulation which, as different institutions are performing several functions, may give rise to issues of competitive neutrality. On the other hand, focusing upon functions means that a given firm will be subject to many different types of regulation and under the authority of different regulatory agencies, depending on the number of functions it performs. A later section discusses an approach to institutional structure based on functions.

In reality, a strict dichotomy between *institutional* and *functional* regulation is misleading as they serve different purposes. In practice, it is institutions and not functions that fail or become insolvent and therefore institutions *per se* need to be regulated for safety and soundness. It is the overall institution that must be the focus of such regulation.

Functional regulation, on the other hand, is about how an institution conducts the various aspects of its business and how it behaves towards customers. If competitive neutrality of regulation is to be upheld, such functional regulation must apply to particular aspects of the business irrespective of which type of institution is conducting it. Irrespective of institutional structure characteristics, there is, in practice, no alternative to a *matrix approach*. Firms may be hazardous either because they become insolvent, or because they behave badly with their customers. This means that, as it is institutions and not functions that become insolvent, all institutions must be subject to *prudential* regulation where safety and soundness is a relevant consideration. On the other hand, it is functions which are to be subject to *conduct of business* regulation. Regulated firms will, therefore, be subject to both forms of regulation.

## THE CASE FOR A *MEGA* REGULATOR

The central practical issue is whether, for Ireland, there should be a single, *mega* regulator encompassing all aspects of regulation (what is now the UK model), or whether different agencies, including the Central Bank, should be responsible for different aspects of regulation and supervision.

One school of thought argues in favour of a single regulatory agency for the full range of financial services and markets. Such a *mega* agency would be responsible for systemic, prudential and conduct of business regulation – for both wholesale and retail business – even though different considerations are involved in each. This was the approach taken by the UK Government in 1997. Several arguments favour such a structure.

- There might be economies of scale within regulatory agencies – most especially with respect to skill requirements. If so, the smaller the number of agencies, the lower should be the institutional costs. A single regulator might be more efficient due to shared resources, etc.
- Similarly, there might also be economies of scope, or synergies, to be reaped between different functional areas of regulation.
- There might be merit in having a simple regulatory structure, one which is readily understood and recognised by regulated firms and consumers.
- There might be advantage in having a structure which mirrors the business of regulated institutions. To the extent that financial institutions have steadily diversified, traditional functional divisions have been eroded. Although there are various ways of addressing overall prudential requirements for diversified institutions, a single, conglomerate regulator might be able to monitor the full range of institutions' business more effectively and be better able to detect potential solvency risks emanating from different parts of the business.

- A single agency should, in principle, avoid problems of competitive inequality, inconsistencies, duplication, overlap and gaps which can arise with a regime based upon several agencies. However, there is no guarantee of this as, in practice, different aspects of functional regulation will be conducted by different divisions within a single agency and problems of co-ordination will still arise.

- If expertise in regulation is in short supply, this might be more effectively utilised if it is concentrated within a single agency. Such an agency might also offer better career prospects.

- Accountability of regulation might be more certain with a simple structure, if for no other reason than it would be more difficult for different agencies to 'pass the buck'.

- The costs imposed upon regulated firms might be reduced to the extent that they would need to deal with only a single agency.

One of the Directors (Briault, 1998) of the newly-created Financial Services Authority (FSA) in the UK has also argued in support of other benefits. [3]

## THE CASE AGAINST A *MEGA* REGULATOR

There is clear merit in the above arguments and there is a certain *prima facie* appeal to the concept of a single regulator. However, several reservations may be made about such a *mega* regulator.

- One of the arguments alleged to be in favour of a single agency is that, as firms have increasingly diversified, the traditional functional distinctions between institutions have been eroded. While this is generally the case, it does not mean that all institutions have converged on a common financial conglomerate model. There remain, and will remain for the foreseeable future, major differences between banks, securities firms and insurance companies. Firms in all sub-sectors of the financial system have diversified, but almost invariably their core business remains dominant. The nature of the risks may be sufficiently different to warrant a differentiated approach to prudential regulation.

[3] Briault points to the following: (i) the harmonisation, consolidation and rationalisation of the principles, rules and guidance issued by the existing regulators or embedded within existing legislation, while recognising that what is appropriate for one type of business, market or customer may not be appropriate for another; (ii) a single process for the authorisation of firms and for the approval of some of their employees, using standard processes and a single database; (iii) a more consistent and coherent approach to risk-based supervision across the financial services industry, enabling supervisory resources and the burdens placed on regulated firms to be allocated more effectively and efficiently on the basis of the risks facing consumers of financial services; (iv) a more consistent and coherent approach to enforcement and discipline, while recognising the need for appropriate differentiation; (v) in addition to a single regulator, single schemes for handling consumer complaints and compensation and a single independent appeals tribunal. This article also contains an excellent statement about the approach to be adopted by the FSA. In this regard, see also Llewellyn (1998).

- A single regulator might not have a clear focus on the objectives and rationale of regulation, and might not make the necessary differentiation between different types of institution and business, e.g. the distinction between wholesale and retail business. Even if the different regulatory requirements of different types of firms are managed within specialist divisions of a *mega* regulator, there is no guarantee that supervisors within the same organisation (but responsible for different types of business) would necessarily communicate and co-ordinate more efficiently and closely than when they are within different, specialist regulatory agencies.

- It is possible that significant cultural conflicts could emerge within the organisation if a single agency is responsible for all aspects of regulation – systemic, prudential and conduct of business – and for all types of financial institutions. Would, for instance, a single conduct of business regulator adequately reflect the fundamentally different requirements, rationale and approach needed for the regulation of wholesale as opposed to retail business? With respect to a *mega* agency which combines both prudential and conduct of business regulation, the Reserve Bank of Australia has argued as follows: "The differences in objectives and cultures would produce an institution which was difficult to manage and unlikely to be clearly focused on the various tasks for which it had responsibility".[4]

- A *mega* regulator would be extremely powerful and this power might become excessive.[5]

- A potential moral hazard might be created in that a public perception could emerge that the risk spectrum among financial institutions had disappeared or become blurred. In particular, the distinction between deposits which are redeemable on demand at face value and investments (e.g.life assurance) where the value of an institution's liability is a function of the performance of the institution in managing its assets, could become obscured.

- There is a danger that a large *mega* regulator could become excessively bureaucratic in its procedures and slow to react to problems as they emerge.

- The creation of a single regulator might involve a loss of potentially valuable information because a single approach is adopted. In effect, there might be merit in having a degree of competition and diversity in regulation so that lessons can be learned from the experience of different approaches. In some respects, the case for not having a monopoly regulator is the same as with any monopolist.

[4] See Thompson, 1996.
[5] As argued by Taylor (1998) in his Twin-Peaks approach:"...(a single regulator), with a remit covering both prudential and conduct of business regulation in banking, securities and insurance and with the power to undertake civil proceedings against those it suspected of insider dealing or market abuse, could potentially become an overmighty bully, a bureaucratic leviathan divorced from the industry it regulates."

- Further, some may doubt whether there are in fact economies of scale to be derived in a *mega* regulator. The economics literature demonstrates quite clearly that diseconomies of scale can also arise in some circumstances. Put another way, what economists refer to as "X-inefficiencies"may arise in a monopolist regulator. It is not self-evident that a single, *mega* regulator would in practice be more efficient than a series of specialist regulators based on clearly defined objectives and focused specifically on regulation to meet clearly defined objectives.

The arguments are finely balanced and the relevant structure might vary between countries, depending on the structure of their financial systems, past traditions, the political environment and the size of the country. If a single agency is created, the issue of internal structure arises. Given the arguments that have been outlined, the objective within a single agency must be to create an internal structure that maximises the potential advantages (economies of scale, etc.), while at the same time guarding against potential hazards (an unwieldy bureaucracy, etc.). Internal structure may be able to contribute to this objective.

## THE UK MODEL

In May 1997, the incoming Labour Government announced a wide-ranging reform of the institutional structure of regulation in the UK, the main features of which are as follows.

(i) Prudential regulation and supervision of banks would be transferred from the Bank of England to the Financial Services Authority (FSA).

(ii) At a later stage, after enactment of legislation, the existing Self Regulatory Organisations would be merged into a single agency, thereby ending the two-tier system which the Government believed was inefficient, confusing for investors and lacking accountability and a clear allocation of responsibilities.

(iii) The Bank of England would retain its role as lender of last resort and its responsibility for systemic stability. (A similar arrangement is being established in Australia.)

(iv) The prudential regulation of all financial institutions, not just banks, would be transferred to the FSA.

As the new, single regulator will be responsible for both prudential and conduct of business regulation and supervision, and for all financial institutions and markets, the UK has clearly adopted the *mega* regulator concept. The result is a major simplification of the regulatory structure. Because of its coverage and scope, the FSA will be the most powerful financial regulator in the world.

## TWIN PEAKS

An alternative approach has been proposed to regulation and supervision, one based upon the objectives of regulation: systemic stability and consumer protection. This approach, known as 'Twin Peaks', distinguishes the two objectives of regulation and argues that systemic considerations do not relate exclusively to banks but include a wider range of financial institutions.

The 'Twin Peaks' concept promotes the case for a single prudential supervisory agency and a single conduct of business agency. The former would apply prudential measures to ensure the soundness of the system, the capital adequacy of banks and control of risk. It would encompass all types of financial institution – including securities firms, fund management institutions, insurance companies – from which a systemic crisis might conceivably develop. The case, as stated by Taylor [6] is that: (i) a wide range of financial institutions are systematically significant; (ii) existing regulatory arrangements (in the UK) raise issues of competitive neutrality as between different types of financial institutions; (iii) the emergence of financial conglomerates requires a group-wide perspective; and (iv) there is a need to pool rare regulatory expertise. In particular, he argues: "A regulatory system which presupposes a clear separation between banking, securities and insurance is no longer the best way to regulate a financial system in which these distinctions are increasingly irrelevant". He recognises that there would be some grey areas within the overall structure proposed, but believes that: "…any system is bound to have its anomalies and illogicalities; it is sufficient that the *Twin Peaks* model has fewer than the alternatives".

The counter argument is that while there has been a degree of convergence between banks and securities firms, there is still a reasonably clear distinction to be made between banks and other financial institutions. Some would argue that banks remain unique and, were a single institution to conduct prudential supervision for everything from banks to insurance companies, it would still need to tailor the rules to meet the characteristics of particular types of business. In effect, the new regulator could quickly become a collection of separate 'Divisions'.

In practice, the real choice for Ireland is probably between a single regulatory agency or the Twin Peaks model.

Something very much like the Twin Peaks approach was recommended by the Wallis Committee in Australia in April 1997 and the recommendations have been accepted by the Government there. The Committee recommended a single conduct of business

[6] See Taylor (1995 and 1996) and Goodhart (1996).

regulator that would cover issues such as disclosure requirements, consumer protection, financial advice, and integrity of market conduct. A Corporations and Financial Services Commission – a prudential regulator for all financial institutions – would be formed though a merger of existing prudential agencies.

Currently the Reserve Bank of Australia is the prudential regulator of banks but not of other financial institutions. The Wallis Committee argued against the central bank being the single prudential regulator. However, it also argued that systemic stability, with respect to the payments system, would remain a responsibility of the Reserve Bank of Australia. The central bank would retain powers of lender of last resort to those institutions involved with the payments system. This issue also arises in the UK as the Bank of England retains responsibility for systemic stability. The International Monetary Fund (IMF) has recently argued: "As regards risk, the separation of banking supervision and lender-of-last-resort facilities will require the FSA and the Bank of England to act in close co-ordination in the event of a crisis". Whether the central bank retaining responsibility for systemic stability is viable without also being responsible for prudential supervision of banks remains to be seen.

There are two quite separate issues involved here. One is the question of whether there should be a single prudential regulator for all financial institutions. The other issue is whether or not the central bank should be a prudential regulator.

## AN APPROACH BASED ON OBJECTIVES

The ultimate criterion for devising a structure of regulatory agencies must be the effectiveness and efficiency of regulation in meeting its basic objectives. On this basis, one school of thought argues that the most appropriate basis for organising the institutional structure is in terms of the *objectives* of regulation. In this approach different agencies are responsible for different objectives of regulation: systemic, stability, prudential safety and soundness of institutions, as well as consumer protection through conduct of business. There are several reasons for this.

- Regulatory agencies may be most effective and efficient when they have clearly defined, and precisely delineated, objectives and when their mandate is clear and precise.
- Accountability may be more effective and transparent when it is clear for which objectives regulatory agencies are responsible.
- A clear, internal management focus may be more likely when the objectives of the agency are clear and precise.

- There are times when the objectives of regulation are in conflict and one of the issues to consider is what structure is most efficient at resolving such conflicts. In a single agency conflicts are internalised. However, and as noted by Michael Taylor in his *Twin Peaks* proposal, this may be judged to be undesirable because the resolution of conflicting objectives involves judgements about important issues of public policy; and these judgements and decisions should be made at the political level and in a publicly accountable way. A merit of focusing institutional structure upon regulatory functions may be that it ensures that significant conflicts between different objectives are resolved at the political level.
- Prudential, systemic and conduct of business dimensions to regulation require fundamentally different approaches and cultures and there may be doubt about whether a single regulator would, in practice, be able to effectively encompass these to the necessary degree. Again as noted by Michael Taylor: "There are already profound differences between the style and techniques appropriate to prudential and conduct of business regulation and these are likely to become more pronounced as prudential regulation moves further in the direction of assessment of firms' own internal risk control systems. It would be difficult to combine two such different cultures within a single organisation".
- It might be argued that the important distinction between wholesale and retail business, and the different approach to regulation which is appropriate to each, would not be adequately reflected within a single regulatory agency.

A counter to some of these arguments would be that, in practice, a single agency would itself be structured internally in terms of different functional responsibilities. However, this in itself would add to internal transactions costs and some of the arguments in favour of a single agency would be weakened in the process.

## THE ROLE OF THE CENTRAL BANK

When each country has decided on its optimal regulatory structure, the next question is the role of the Central Bank within that structure. The first issue to be addressed is that of power. A survey of international experience is provided by Charles Goodhart .[7] Of the eight countries in the world that currently have in place a single, all-embracing financial regulatory authority (including the UK), all but one have made this separate from the central bank; the sole exception is the Monetary Authority in Singapore. This is not accidental. Particularly if the central bank has independent powers to set interest rates, the combination of a widespread regulatory function with monetary control might be thought to place excessive powers within the hands of unallocated officials.

[7] See Goodhart *et al*, (1998), Chapter 8.

The next issue is that of possible conflicts of interest. This is frequently advanced by academic economists as the main argument against central bank participation in regulation, in the belief that a central bank with responsibility for preventing systemic risk is more likely to loosen monetary policy on occasions of difficulty.[8] Indeed, there is a slight statistical relationship between responsibility for regulation and higher inflation, but this is due to the interaction between the regulatory role and dependence in the central bank. There is no reason why assistance to individual banks in difficulty need affect the aggregate provision of reserves or level of interest rates. Any lender of last resort assistance can, in the aggregate, be offset by open market operations. Furthermore, cases where the banking system of a country gets into serious difficulty – as in the USA 1930-33, Japan 1992 to date, Scandinavia in the late 1980s and early 1990s, the UK during 1974-75 – are much more likely to be periods of deflation than inflation and the really serious sins of omission are of insufficient support in such cases. Goodhart and Schoenmaker (1995) came across few cases where the concern of a central bank for the solvency of its banks has been a major factor in an excessively expansionary monetary policy.

Indeed, the question of conflicts of interest might in some cases be an argument in favour of giving the central bank such regulatory responsibilities. The question here is, if not the central bank, then which other body will have such powers and what conflicts of interest might they have? If the central bank does not play this role, will it then be given to a body more subject to direct political influence? If public policy conflicts do arise, they will do so irrespective of whether supervision is a responsibility of the central bank. Such conflicts may arise whatever institutional structure is created and they must be resolved somehow. The key issue is whether the transaction costs of resolving them are greater or less when they are resolved internally rather than externally. A particular view on this issue has been put by the Reserve Bank of Australia, as provided by Thompson (1996):

> "By supervising banks, (the central bank) gains first-hand knowledge and 'feel' for financial market conditions and for the behaviour of those institutions which are a key element in the transmission of monetary policy changes to the general economy. This can be an important input into monetary policy decisions. There are more likely to be complementarities between supervision and monetary policy than conflicts, and any conflicts that do arise will need to be resolved however the various responsibilities are allocated."

The Reserve Bank of South Africa has devised something of a working compromise between the opposing arguments about the location of bank supervision. This has been achieved by establishing an 'arms length relationship' between the Office of the

[8] For example, Cukierman, 1992; Brimmer, 1989; Heller, 1991.

Registrar (of banks), which is located within the Reserve Bank, and the Reserve Bank itself and particularly its role as lender of last resort. Despite being a senior Reserve Bank official, the Registrar has some autonomy and independence in the administration and implementation of his functions, but also clearly defined restrictions when it comes to decisions on monetary policy. This seems to accept a degree of inevitability that, at least in the current circumstances of South Africa, the central bank must have some role in bank supervision; though an attempt has been made to guard against some of the potential hazards involved in such arrangements.

Perhaps the term ‘independent’ should be put in quotes, since no bank regulator could, or should, ever in practice be actually independent of the central bank. The central bank is the monopoly provider of the reserve base and lender of last resort. Any serious banking problems are bound to lead to calls for the central bank to use its reserve-creating powers. Moreover, the central bank, in its macro-policy operational role, must have a direct concern with the payments and settlement system, the money markets and the development of the monetary aggregates. Any serious problem with the health of the banking system will touch on one, or more, of these concerns. So there is bound to be, and must be, very close relationships between the bank regulator and the monetary policy authority. Establishing such relationships will be one of the priorities in the structural reform of the regulatory structure in the UK.

This need for co-ordination might suggest unifying the functions within the central bank. But, for a variety of reasons – including the need for confidentiality – when the central bank combines both roles, the supervisory department is usually separate from the monetary policy department. Co-ordination is then only regarded as necessary between the top officials. Such regular meetings of senior officials can be organised just as easily whether their subordinates are in separate, or the same, buildings, and whether their organisation is formally separate or not. Perhaps the only real difference is that disagreements between senior officials would be settled (quietly) within the central bank in the case of unification and outside the bank, presumably by the Minister of Finance and with more likelihood of publicity, in the case of separation. However, it is hard to identify actual cases of publicly-observed disagreement between the central bank and the separate bank regulator in countries where there is such separation.

A final issue relates to the finance of bail-outs, should they occur. Owing to fraud, mismanagement, or simply incidents of extreme volatility in asset markets, some banks, including perhaps very large banks, may become insolvent. It used to be possible, at least on some occasions, to resolve such situations by a rescue; a ‘life-boat’, organised by the central bank and paid for by a voluntary levy on the remaining commercial banks. The increasing diversity within, and competition among, the banking sector will make that almost impossible to arrange in future years. Such rescues depend on the existence of a well-defined 'club' of banks, who are prepared and able to spend shareholders' funds to protect the reputation and the privileges of that club. With a mixed bunch of niche, specialist and universal, domestic and multinational banks, agreement to pay out funds to revive an ailing competitor could not be achieved.

The implication of this is that any large rescues within the banking field will, in future, have to be financed by taxpayers'funds[9]. If so, the central government, politicians and Ministries of Finance, will have to be involved in any large failures/rescues. This, in turn, will have a bearing on the question of the relationship between the body charged with the maintenance of systemic stability and the central bank.

The bottom line is that banking realities will necessitate considerable co-ordination and interaction between the senior officials dealing with monetary policy and with bank regulation. The question whether the banking supervisory body is formally within, or outside, the central bank is then essentially a subsidiary issue, depending on perceptions of the appropriate locus of power and responsibility. These perceptions will vary depending on the accidents of history and culture. There is no single, best approach under all circumstances, as is clearly evidenced by the variety of regulatory structures currently in place in different countries.

## IMPLICATIONS OF EMU

Important issues also arise with respect to the role of the central bank in the context of EMU and the common currency. Three issues in particular are considered. Does EMU have implications for the debate about whether national central banks should be the supervisory agency of banks? Should bank supervision remain a national responsibility? Who is to be responsible for systemic stability and the lender-of-last-resort role in the Union as a whole?

It is necessarily the case that, within the EMU, national central banks have no power to unilaterally set monetary policy as this becomes an EMU-wide responsibility. This lessens the power of the argument of those who believe the central bank should not be responsible for banking supervision on the grounds of a potential conflict of interest with respect to the conduct of monetary policy. Any such conflict, even if it were real when the national central bank has autonomy over the conduct of monetary policy, evaporates in the case of EMU.

[9] See Goodhart and Schoenmaker (1995).

There is a second issue: namely, whether the supervision of banks should remain a national responsibility, or whether this too should be ceded to a union-wide authority which may or may not be the European Central Bank. For the foreseeable future, it will remain a national responsibility and, in the author's view, and applying the general principle of subsidiarity, it should remain so,. Nevertheless, given that banks are now operating in a wider currency area, and the potential transnational, systemic implications of bank failures are greater, there is an evident need for enhanced collaboration between national bank supervisors within the monetary union. In a recent statement, the European Shadow Financial Regulatory argues that, in the long run, there will be a need for a union-wide structure for monitoring systemic risk. It also argued that it will be necessary to reassess existing provisions for the lender of last resort.

At present, supervisory co-ordination is based on bilateral Memoranda of Understanding. However, closer market integration under EMU demands intensified co-operation between supervisors and central banks both at national and European levels. It is important that such co-operation be underpinned by a clear EU-wide agreement on a code of conduct covering supervisory responsibilities and standards in order to avoid misunderstandings, institutional rivalry and excessive forbearance by national supervisors. In this context, the ECB could act as a clearing house for co-operation agreements between national supervisors at EU and international levels. The co-ordinating mechanism should in particular make provision for the allocation of responsibilities in times of crisis. Such co-ordination at the European level would represent a contribution to global financial stability. As the euro capital market deepens, and pan-European financial groups develop, the co-operative mechanisms will need to be supplemented by a Union-wide structure. This is because any supervisory shortcomings in a particular jurisdiction would be quickly felt in other Member States.

There are also several issues related to the lender-of-last-resort role. Given that intervention has both monetary and fiscal implications, there are several issues that need to be resolved. Firstly, the respective roles of the European Central Bank and national central banks need to be determined in the event of a national or EMU-wide liquidity crisis. Formally, the European Central Bank has no lender-of-last-resort role and there is no institution charged with responsibility for providing or co-ordinating the provision of liquidity in a crisis. In effect, there is no EMU-wide lender of last resort. Secondly, there needs to be an unambiguous framework for crisis management: who plays what role? Thirdly, it needs to be resolved whether a national central bank is able to intervene in a local liquidity crisis without the permission of the European Central Bank.

In the long run, the development of a pan-Union capital market and banking system will require unambiguous mechanisms for surveillance of systemic risk and for systemic crisis management and resolution.

## ASSESSMENT

The institutional structure of regulation has recently become an issue of public policy debate in several countries which suggests a certain unease about prevailing structures. International experience indicates a wide variety of institutional regulatory formats which signals that these are influenced by national characteristics about, for instance, the structure of the financial system. It also suggests that there is no universal ideal model.

A key issue is whether the regulatory structure has an impact on the overall effectiveness and efficiency of regulation and supervision, since this should be the ultimate criteria when making judgement between alternative formats.

While institutional structure is important, in itself it does not guarantee anything about effective and efficient regulation and supervision, and it would be hazardous to assume that changing the structure of regulatory institutions is itself a panacea.

With the emergence of mixed financial institutions, the case for a *mega* or conglomerate regulator might have a certain *prima facie* appeal, as it mirrors the emerging structure of financial systems. However, there are reservations to this and some prefer an institutional structure more closely focused on the objectives of regulation. Nevertheless, it is recognised that a perfect institutional structure is a chimera and we have to accept the inevitability of working within an imperfect structure: it is not possible to fully capture an untidy marketplace in a perfectly neat set of regulatory boxes.

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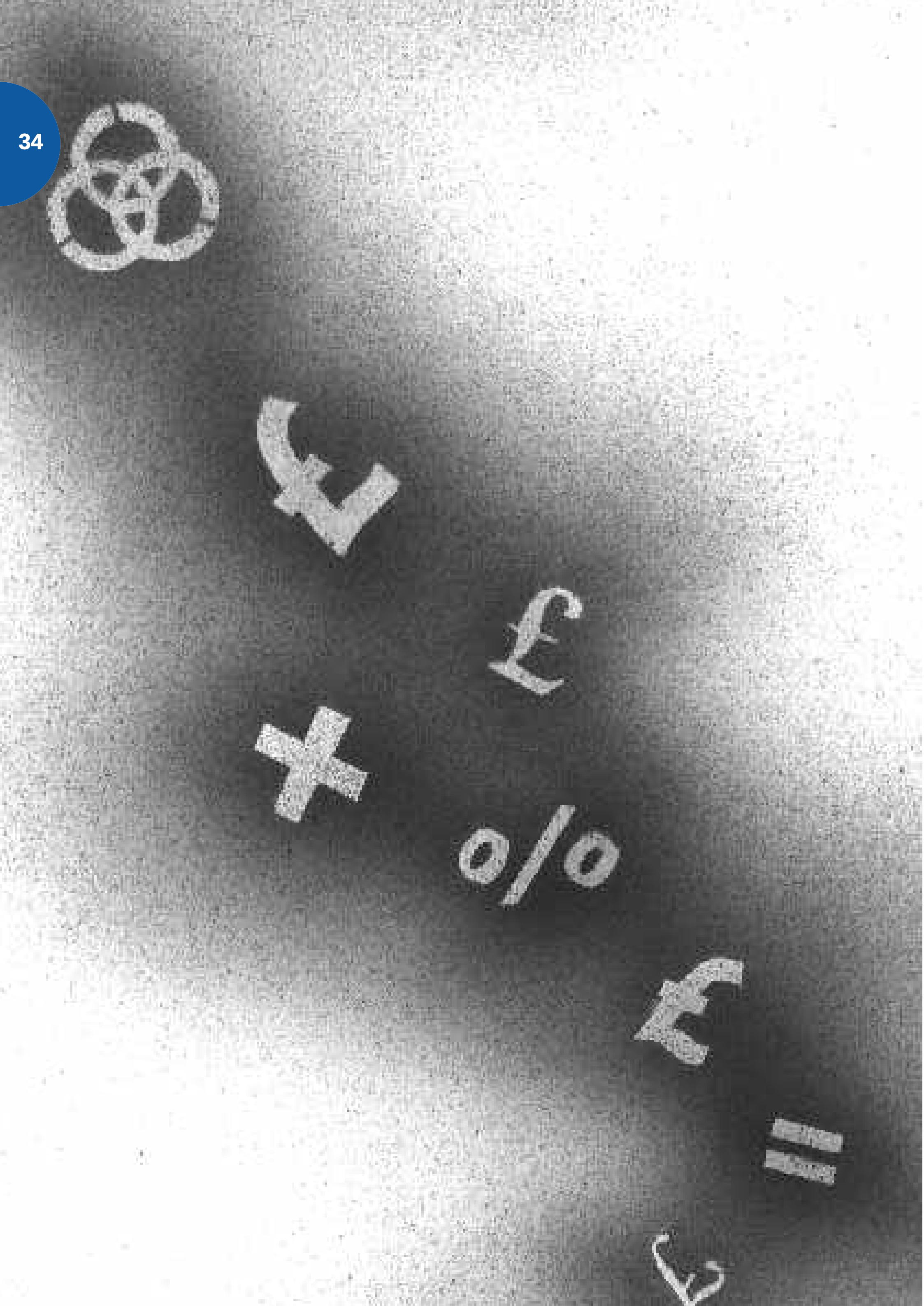


# E- COMMERCE AND CONNECTING TO THE CUSTOMER

**Andy Collinge, Manager,**
**Ernst & Young Management Consultancy Services** [1]

The most successful financial services firms of the coming decade will be those whose primary business strategy is focused on providing more sophisticated, customer-focused products and services. They will invest in technology which gives them an accurate picture of individual customer preferences and patterns of behaviour, allowing them to measure the value of specific customers on the basis of their *actual* behaviour rather than their *assumed* behaviour. They will apply sophisticated computer analysis to their customer data to deliver the right product through the right delivery channel and at the right price. By better understanding their customers, they will be able to direct their marketing and customer services with greater precision and effectiveness. The techniques and technology needed for the task of better connecting with customers already exist. Interestingly, most of the development and refinement to date has been carried out not by financial institutions, but by organisations outside the financial services industry which are destined to become their most potent competitors.

## THE VALUE NETWORK

The concept of the value network describes a cross-enterprise operating model which forward-looking financial companies are using to increase their competitive positions. Value networks are formed when banks, insurance companies and other financial services providers collaborate to offer customers comprehensive packages of financial services, delivered via branch/agency offices and other electronic means (e.g., ATMs, call centres, personal computers). The value network is becoming the dominant competitive model in the marketplace and companies are increasingly meeting the requirements necessary for its effective management. Since introduction of this concept, two significant trends have evolved.[2]

[1] This article draws on the Ernst & Young ‘Special Report on Technology in Banking and Financial Services’, 1998.

[2] Ernst & Young first introduced the concept of the value network in 1996.

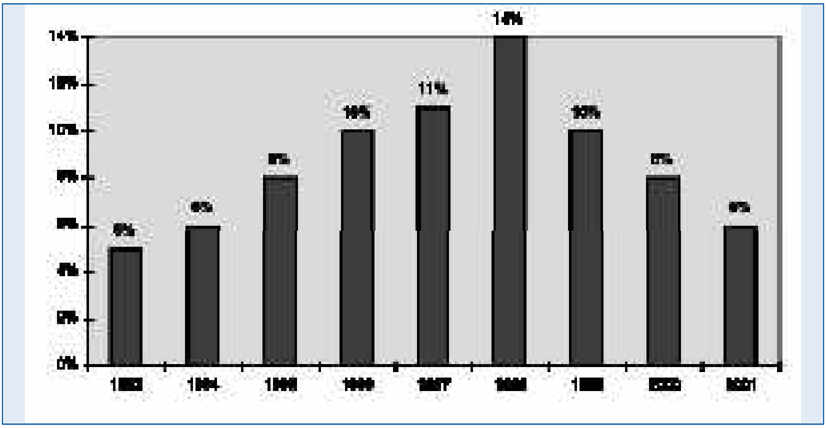
- Financial institutions are forming their future business strategies around core competencies augmented by service bundles – the combination of products and services – from other providers. In other words, most institutions are no longer attempting to be all things to all people using only their own resources. This segmentation is being driven by companies which excel, or intend to excel, at Operational Excellence, Mass Customisation, or Relationship Management.
- Technology is enabling customers to conduct their own business. Technology is not changing the "business battleground;" it is changing the speed at which the "battle" occurs. Ultimately, financial institutions are still occupied with servicing the customer base, cost containment and risk management. In effect, e-commerce and the Internet, from the customers' point of view, are accelerating the pace of change towards the value network operating model.

## FINANCIAL SERVICES AS CONSUMER PRODUCTS

In the US, asset management companies – including banks and insurance companies performing asset management functions – continue to successfully increase market share by offering a broad and diversified set of products and services. Asset managers, positioning themselves as managing customer relationships, rather than simply products, have shown significant growth in both revenue and profit. A key element in their success has been the use of technology to facilitate customer connection and transaction processing. Much of this growth has occurred as more and more financial companies create "value networks".

Financial institutions are also learning directly from the experience of consumer product companies, which have long recognised the role of technology in understanding their customers. It is no coincidence that, in recent times, some very senior appointments in the financial services sector have come from consumer marketing backgrounds. Consumer products companies are spending massively on technology for sophisticated data management purposes. Most of this spending is on point-of-sale devices and software which allow them to analyse consumers, delivery outlets, suppliers and product promotions. In the retail sector, data warehousing has long ceased being an expensive luxury and is now a competitive necessity.

FIGURE1:TOTALTECHNOLOGY SPENDING, % YEAR-ON-YEAR



The most recent research by Ernst & Young [1] has found that financial services companies globally are budgeting to spend 14% more on IT in 1998 than they did in 1997. The discretionary component of that spending is being allocated mainly to retail customer sales and service relationships. Retention of existing customers – and increasing the revenue from those customers – are the overwhelming priorities for most respondents, particularly in mature and competitive markets such as the US. Much of their technology budget is earmarked for new ways of using the customer information they gather every day and linking it in real time to branches, telephone service centres and other customer interaction points. Some 83% of survey respondents said they now use data warehousing and, of those, nearly three-quarters cite customer retention as their primary objective.

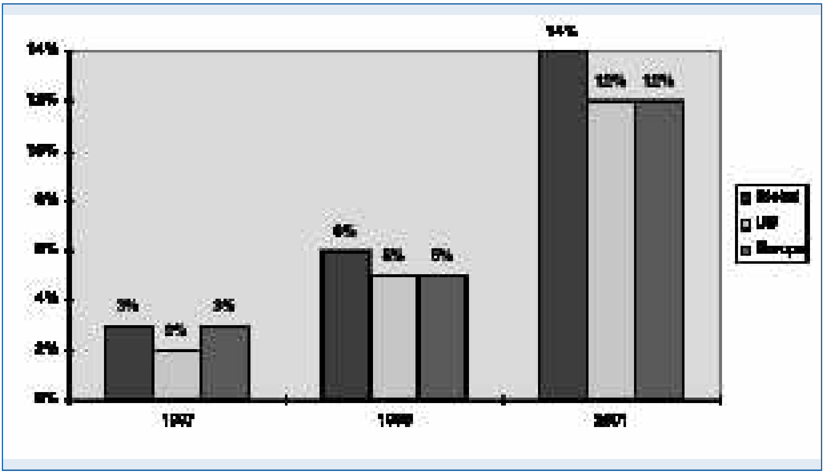
## MARKETING TO A SEGMENT OF ONE

Data warehouse technology provides the customer-specific information which organisations can use to bundle and re-bundle their products to meet the diverse needs of different market segments. In fact, the tools now available allow profiling down to individual customer level – a segment of one.

Propensity modelling – using advanced computer techniques such as neural networks – allows researchers to predict the response of individual customers to different scenarios. This knowledge can then be applied in finely targeted marketing campaigns, or to support call centre representatives assigned to specific product areas or customer segments.  It can also be used to develop more efficient pricing strategies.  Dynamic data gathering and new analytical techniques are also of value.

Old assumptions about the relative profitability of different demographic groups are also being challenged and found wanting.  For example, people with limited economic resources may be willing to pay additional fees for financial planning advice, whereas more affluent individuals may be financially more sophisticated and not necessarily interested in advice.  Customers may also be priced in or out of delivery channels, as organisations attempt to influence customer behaviour and overcome resistance to new technologies.

**FIGURE 2: TOTAL BUDGET FOR E-COMMERCE AS % OF TOTAL TECHNOLOGY SPENDING**



As well as showing the dollars being poured into warehousing and mining customer data, the Ernst & Young survey shows how electronic commerce – and the Internet in particular – is accounting for a growing share of organisations' technology spending. The e-commerce component of respondents' technology budget is expected to double from 3% in 1997 to 6% in 1998 and to more than double again to 14% by 2001.  The spending mix is also set to change significantly.  Most notably, spending on Internet-related technology is forecast to grow dramatically, from 1% in 1996 to 24% in 1998 and rising to 57% of the technology budget by 2001.

## E-COMMERCE – THE EVOLVING MODEL

Many financial institutions believe that e-commerce is reshaping their customer model. For them, a clear imperative is the need to address the way they can successfully 'connect with the customer' in order to acquire, develop and service a mutually profitable relationship. While institutions do not foresee any major changes in how they will form 'value networks' as a result of e-commerce, they nevertheless believe that in order to remain competitive they must focus on connectivity, partnerships and alliances in the context of e-commerce. This belief is set in the context of poor global information in relation to e-commerce strategy, acceptance and competitor information.

The definition of customer communication is changing. In the past, the customer was seen as a passive recipient of information. Today the focus is on interaction, with the fundamental recognition that customers will initiate, as well as respond to, direct communications. Four interactive customer communication channels have emerged to complement the existing branch network. These include ATM/Kiosks, Call Centres, Interactive Voice Response (IVR) and E-Commerce.

A predictable future trend is the convergence of these channels, but currently they are characterised by varying degrees of isolation. Isolation at the point of contact with the customer typically includes lack of consolidated customer identifiers, inconsistent company image, etc. Within the back office, a lack of integration is evident in related systems and processes. The importance of total integration is to ensure that the customer's multiple ongoing points of contact with the organisation are consistent and positive.

The financial services industry has long faced issues such as disintermediation, new product development and strategic alliances. The survey results show the industry anticipating the mainstreaming of e-commerce, which will irrevocably alter the financial services landscape.

In trying to understand the diversity of approaches to e-commerce, two primary factors come into play. The first relates to the company's "e-commerce doctrine," a measure of the organisation's ability to articulate the expected impact of e-commerce on the company. The second factor relates to "technology enablement", a measure of the organisation's belief in the role of technology in differentiating its value proposition. Positioning a company in relation to these factors sets the context for understanding its e-commerce investments, partnerships and deployment. While there are an infinite number of possible positions along these axes, the industry broadly falls into three categories of e-commerce doctrine and three categories of technology enablement, thereby yielding nine styles of e-commerce strategy. As presented below, the former are described as holding, formative and committed; the latter can be broken into the three principal categories of observers, exploiters and innovators.

| E-COMMERCE DOCTRINE | | |
|---|---|---|
| **Holding** | **Formative** | **Committed** |
| Those companies in the holding category cannot articulate an e-commerce strategy and/or believe they currently lack the data to form a business case for e-commerce. This does not imply lack of effort or ability in the company. These companies hold that the market is currently too immature to assess its effects and moving into the formative category would be a costly mistake (i.e. funds would be invested and lost, scarce resources would be squandered). | Those in the formative category can articulate how they believe e-commerce is likely to effect the industry, but not how they should respond. They are testing the waters trying to validate one or more potential strategies | Committed companies have an initial e-commerce position and resources allocated accordingly. Note that committed may not imply redoing the business for e-commerce, as the strategy could be that e-commerce will have only a minor impact on a few offerings within a small sub-set of the target market. |

| TECHNOLOGY ENABLEMENT | | |
|---|---|---|
| **Observers** | **Exploiters** | **Innovators** |
| Observers use proven technology as required by the market. They feel the role of technology is primarily to reduce costs. | Exploiters use technology to stay current with their product and service offerings. They see technology as having the potential to create competitive advantage, but do not believe that the risk/reward trade-off requires them to move first in the marketplace. | Innovators aggressively use technology to try to capture competitive advantage. They see technology as a way to strategically shift market share. |

Based on the survey data and information gathered from face-to-face interviews, more than 50% of financial companies considered themselves as formative/exploiter. Less than 5% would place themselves in the committed/innovator category and about 20%-30% would describe their strategy as holding/observers.

Most see their future in migrating from the holding/observer to committed/innovator. They see this occurring over a number of years, working in partnership with others (non-financial institutions in many cases) and using standards as much as possible in this process. Not surprisingly, these attitudes toward technology which appear generic are not strictly e-commerce based, and have parallels in earlier technology initiatives, such as client-server architecture and large-scale database technologies.

It is arguable that the position of formative/exploiter is perhaps the worst position to occupy. It is an expensive position, siphoning scarce finances and other resources without major benefits which could be expected to gain competitive advantage.

## E-COMMERCE SPENDING AND GOALS

Bank branches, insurance agencies and brokerage offices, traditionally the primary point of customer contact for the finance industry, are now considered one among many channel priorities. This is not to say that the “branch/agency concept” is disappearing, but its role is changing. Survey findings indicated that the industry has, in general, recognised the importance of the direct e-commerce channel and plans to allocate significant resources to develop the information infrastructure required to exploit it.

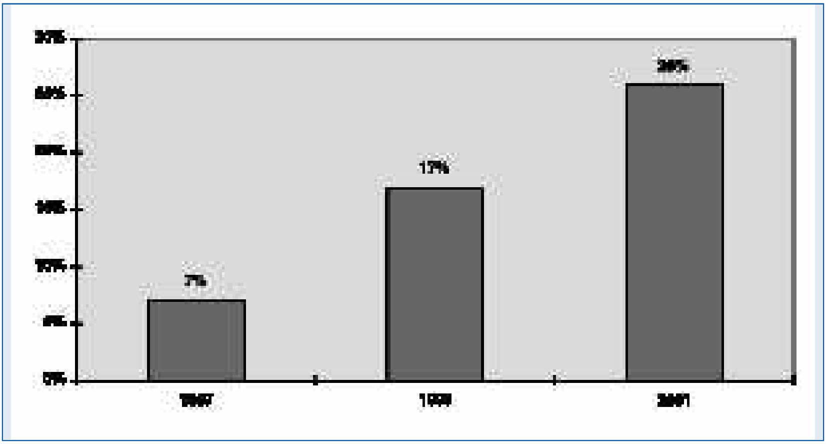
One of the greatest challenges faced by the industry is the ability to integrate the multitude of existing channels into a seamless delivery environment. As channels multiply, so too do the business and technical challenges associated with their management. The development of e-commerce as yet another delivery channel will add to already increasing operational costs, as current developments are not taking advantage of existing infrastructures. The development of e-commerce as a channel will also help financial service providers to make changes in other channels.

Respondents indicate that, by 2001, they plan to spend 14% of their technology budgets on e-commerce, a proportion roughly equivalent to that which is spent on branches/agencies today. The stated growth in e-commerce spending is far out-stripping that of technology as a whole. Respondents allocated twice the proportion of 1998 technology budgets for e-commerce compared to 1997.

Additionally, anticipated growth in e-commerce as a percentage of the total technology budget is about to explode by a 33% compound annual growth rate (CAGR). Such astonishing e-commerce growth, both in absolute value and as a percentage of total technology spending, must imply fundamental shifts in the context of financial services. Based on a composition of data findings, this optimism appears to stem from, as yet, unrealised cost savings which are projected to come from significant increases in transaction volumes that will not involve large incremental IT investments.

Respondents foresee enormous growth in e-commerce transactions in the next two years, more than doubling from 7% of total purchase and settlement transactions in 1997 to 17% of the total in 1999. The growth rate from 1999 to 2001 will rise from 17% to 26%, highlighting industry-wide optimism. It is evident from the survey that respondents foresee great potential for e-commerce, even though it is unlikely that companies will attain even a 3% reduction in operational costs in 1998 due to e-commerce, with even less reductions likely going forward. These estimates show an industry-wide optimism which has yet to be realised.

**FIGURE 3: EXPECTED INCREASE IN E-COMMERCE TRANSACTIONS AS % OF TOTAL**




As yet, e-commerce in its various forms has not had a significant impact on bottom lines. Operating costs have fallen, but not substantially, and the real pay-off is expected within the next five years or so. In addition, the implementation of e-commerce is increasing operating costs as financial services organisations fail to integrate and consolidate delivery channels

Surprisingly, and contradicting recent media reports, e-commerce is being used primarily as a defensive strategy by financial services providers. E-commerce strategy is primarily focused on customer retention and the reduction of operating costs as key business goals. This is seen particularly in those organisations described as formative/exploiters that spend money on existing solutions, but not innovation. As previously indicated, this stance may be the worst of both worlds.

In addition European institutions are significantly less focused on increasing revenues through e-commerce than their American and Australian counterparts. However, European respondents are significantly more focused on using e-commerce in pursuit of new customers than are U.S. companies. The U.S. seems to be taking a more traditional, wait-and-see approach, while their European counterparts, with a well-established e-commerce base of operations such as POS and GIRO systems, focus more on new customers and new markets.

Ironically, the very infrastructure that makes it easier to deliver the breadth of products and services also makes it easier for customers to compare and contrast competitors, or go to third-party sites that provide these comparisons. Increasingly, as companies play catch-up to small, high-tech competitors, they may be inadvertently accelerating the issue of dwindling customer retention. Rather than emphasising experience, customer service, and value-added features, large companies are increasingly competing on cost and technology – the clear road to commoditisation.

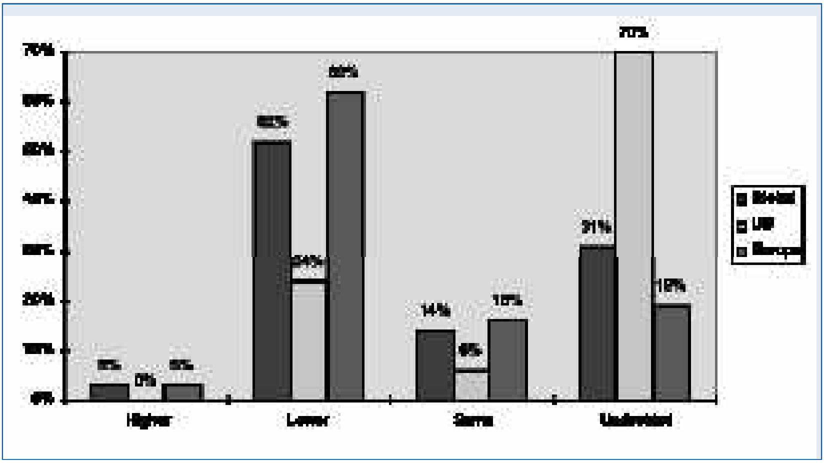
Most companies will implement self-service automation features to enable customers to conduct basic requests themselves, thus freeing a diminishing pool of relatively expensive customer service representatives to undertake more judgement-intensive tasks.

## PRODUCT PRICING

Once a company begins to offer products and services online, the remaining challenge is how to price them. Is pricing based on current formulae, on a cost-plus basis for the new infrastructure, or on a value-added basis? The respondents were unsure: 31% remain uncertain as to whether to price e-commerce products and services higher, the same, or lower than their bricks-and-mortar counterparts. Rational pricing for online offerings awaits further technological developments. A brand position of a “fair deal” vendor, using a “cost-plus”pricing model, would tap into the dynamics of the online market just right. An alternative strategy is to give away solutions for a limited period of time, with the intent of transferring users into the paying category over time. Typically used with technology that is not the best in the marketplace, this method requires a costly game of "catch-up" – catching up on paid customers and catching up on technology, a risky proposition.

The most important issue to address in interpreting these findings is the business model implied by the choice. What is the return-on-investment (ROI) analysis of charging less for comparable services delivered over the Internet? The common wisdom is that the cost of e-commerce services is considerably lower than that of the "bricks-and-mortar" equivalents. As such, while a portion of these cost savings is transferable to customers, net margins should increase.

**FIGURE 4: HOW TO PRICE E-COMMERCE**




However, it seems that the common wisdom – that e-commerce has a logical and easy-to-understand business case – is in some doubt. Reinforcing this conclusion is the relatively large number (31%) "Undecided" about plans for e-commerce pricing, as well as the 3% who will charge more for e-commerce offerings than for non-e-commerce products and services. Regionally, these trends are even clearer: fully 70% of the U.S. respondents remain undecided on pricing, compared to only 19% of Europeans. In contrast, 78% of Canadian companies and 62% of Europeans versus 24% of U.S. respondents anticipate pricing e-commerce products and services lower than those delivered over traditional channels.

Examining these options in more detail, a significant number of low-cost competitors in the e-commerce arena argue that pricing e-commerce the same as current services is not likely to be a viable business model. Even those companies which decide to price e-commerce offerings lower than equivalent “bricks-and-mortar” world products and services should proceed with extreme caution. Purchasing (or developing) and implementing new e-commerce tools and technology will initially be costly; and unless there is assurance that the reduction in fees does not outstrip cost reductions, there may be unfortunate surprises in store for some early adopter companies. If the differential between reduced fees and reduced costs is positive but small, then profitability is dependent on higher volumes— which are coming, but not next year. Institutions will need disciplined cost accounting and deep pockets to ride out the current uncertainty and establish a cost-effective, e-commerce pricing model.

It is important to realise that the regulatory infrastructure is not in place to enable and support the e-commerce vision. The licensing of financial agents to work online, for example, is two years away from resolution. The next two to three years offer an opportunity to assess preparedness for e-commerce and to take remedial action regarding the gaps that will inevitably arise. After that window closes it will be much more difficult to catch up.

## AREAS OF CONCERN

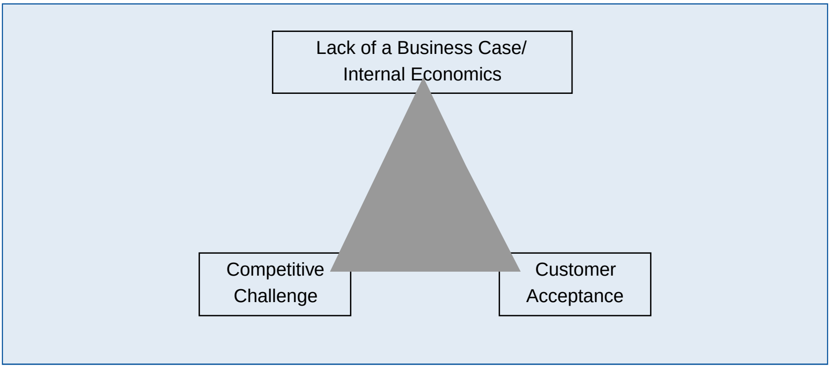
E-commerce security remains the most significant concern in implementing e-commerce solutions. As e-commerce spreads and businesses develop more partners over more channels and via more retail devices, the issue of security dramatically increases. This heightened concern will feed large-scale development and deployment of costly emerging technologies, such as smart card readers, fingerprint, or other biometric security devices. However, the issue of security is primarily a technical one and significant advances in security technology are imminent. It is only a matter of time before security is no longer seen as the primary barrier to the acceptance of e-commerce as a secure delivery mechanism.

More fundamental to the successful development of e-commerce is the concept of **The E-Commerce Dilemma**. This concept highlights the three key issues affecting financial services providers in their attempts to develop e-commerce as a viable proposition. These can be summarised as follows.

- Institutions are finding it difficult to develop a sound business case for e-commerce and have a poor understanding of the internal economics of electronic commerce. The argument on the part of some institutions regarding the lack of a defined business case for e-commerce is that a business case is difficult to structure – and most others do not have one either. However, institutions should at least have structured and documented reasons for pursuing e-commerce – even if they are not, as yet, in the form of a formal business case.

- Customer acceptance of e-commerce, particularly in Europe, is relatively low, with security, speed of transactions, initial set-up costs and the myriad of existing channels all acting as significant factors. It has been argued recently that, although e-commerce is seen as providing significant benefits to the financial institutions, it offers little benefit for the customer over existing channels. Financial service providers still have some way to go in convincing customers of the benefits.
- Intelligence on competitor positioning and strategy is poor as most institutions are struggling with the same issues. The competitive challenge is less clear than one might think. Institutions are struggling with is whether there competitive advantage to being first or loss of competitive position through watching and waiting and responding after the event.

**FIGURE 5: THEE-COMMERCEDILEMMA**

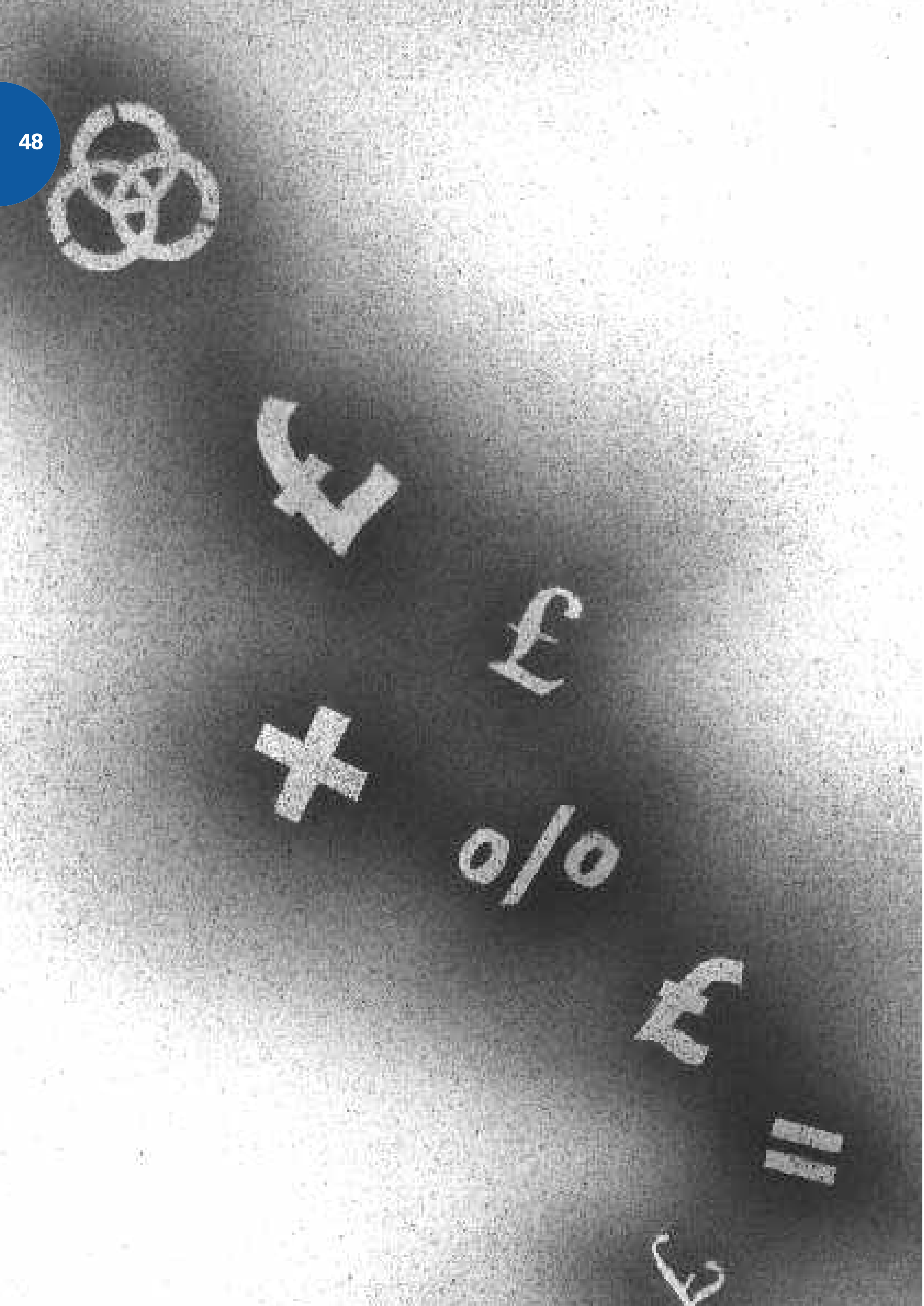



## THE CHALLENGE

Many non-traditional players are now entering the financial services market. The advantage for many of these new players is that they can use new technology to make rapid inroads into the higher-profit sectors of the market, such as asset management. From a standing start, they can quickly build sophisticated databases and, with no traditional branch structure to maintain, can set up highly-focused marketing systems to deliver products and services through the most efficient e-commerce channels.

The risk for traditional financial institutions is that their legacy – both cultural and physical – will leave them fighting over the less profitable end of the business. The pressure is on to make best use of what competitive advantages they have. Chief among these are the established customer bases and the recognised and respected brand names of the traditional financial institutions. However, some of the larger entrants have significant non-financial brand credentials which are being successfully traded in the financial services arena.  Smaller entrants are faced with the task of establishing their brand credentials or forming allegiances with others who have already established brand identities.

Thus, the challenge facing established financial services organisations is to position themselves as successful relationship managers and leverage their established customer connections.  They need to design operating models which integrate all their interactions with their customers and apply the data they collect in accordance with strategies developed for each customer segment.  To achieve this across multiple business units will require a strong shared vision, a culture of co-operation and knowledge sharing, as well as highly effective customer information and performance management systems.



# DEVELOPMENTS IN THE RETAIL GROCERY TRADE

**David Duffy,**
**Economic and Social Research Institute***

Recent years have seen significant change and upheaval in the Republic's retail grocery sector. Always an intensely competitive market, this competition has increased with the growing interest of foreign multiples. The strength of the Irish economy, a changing demographic profile and changing lifestyles are some of the main factors behind the process of change. However, the most significant development has been the arrival in 1997 of the UK multiple, Tesco, raising the – as yet – unresolved issue of superstore development. If superstores were to become a feature of the Irish marketplace, this would have widespread implications for the retail trade in general. At the same time as these changes are occurring, the sector must prepare for the euro's impact on pricing policy and competitiveness.

## PROFILE OF THE SECTOR

The retail sector encompasses a range of diverse activities within which the grocery trade is one of the main activities. Expenditure on food, drink and tobacco now accounts for approximately 31% of total consumer expenditure. Outlets in the retail grocery sector represent nearly 19% of total retail outlets. In itself, the retail grocery segment is quite diverse as it includes the small corner grocery shop, convenience stores as well as the multiples such as Superquinn, Dunnes Stores and Quinnsworth/Tesco.

The 1988 Census of Services (CSO) defined the retail grocery sector as supermarket, delicatessen and other grocery. For comparison with later years it is necessary to include a further sub-sector, grocery with public house. This more widely-defined sector accounted for 21% of retail businesses in the State in 1988 and 27% of retail employees. Annual turnover (excluding VAT) amounted to £2.3 billion in 1988. However, only 4.3% of businesses had a turnover greater than £1 million. The 1988 Census also found that the five major multiples, each with ten or more outlets, accounted for just over half of total turnover.

*The author is grateful to Jim Power, Bank of Ireland Group Treasury, for his helpful suggestions and comments.

The most recent data available for the retail sector relate to 1996 (CSO, Annual Services Inquiry). These figures show that there are nearly 32,000 retail enterprises in Ireland. The retail grocery sector is taken to be retail sales in non-specialised stores with food, beverages or tobacco predominating. This is broadly comparable to the definition in the 1988 Census. Of these, 5,655, or nearly 18%, are in the retail grocery segment. Annual sales in 1996 amounted to £4.3 billion (excluding VAT). The retail grocery trade is also an important source of employment with 42,624 employed in 1996, of which the majority (53%) was full-time.

**TABLE 1: RETAIL GROCERYTRADE IN IRELAND, 1988 AND 1996**

| | 1988[1] | 1996[2] |
|---|---|---|
| **Number of enterprises** | 6,345 | 5,655 |
| **Turnover excl. VAT, £ bn** | 2,339 | 4,302 |
| **Wages & salaries, £'000** | 146,178 | 354,127 |
| **Number of employees** | 25,594 | 42,624 |
| **Number of persons engaged[3]** | 35,628 | 50,971 |

1 Based on the 1988 Census, this includes supermarket, delicatessen, other grocery and grocery with public house.
2 In the 1996 Annual Services Inquiry, NACE 5211, retail sales in non-specialised stores with food, beverages or tobacco predominating, is broadly equivalent to the 1988 Census grouping. The figures shown do not include department stores.
3 Number of persons engaged includes proprietors and family members not paid a regular wage/salary.

Source:Central Statistics Office

A breakdown of the number of retail grocery enterprises by size for 1988 and 1996 (Table 2) shows that, while small and medium-sized enterprises continue to be important, there has been an increase in concentration in the sector. In 1988 some 75% of enterprises employed three persons or less. By 1996 this had fallen to 57%. In contrast, the number of enterprises employing 20 or more rose from just 1% in 1988 to nearly 4% in 1996. In 1988 enterprises employing three or less accounted for nearly 17% of persons engaged. By 1996 this had declined to nearly 10%. Enterprises employing over 20 people accounted for 62% of total persons engaged in 1996, up from 49% in 1988.

**TABLE 2: RETAIL GROCERY ENTERPRISES BY SIZE, 1988 AND 1996***

| | Number of Enterprises | | Persons engaged** | |
|---|---|---|---|---|
| **Persons Engaged** | **1988** | **1996** | **1988** | **1996** |
| **1** | 1,678 | 1,074 | 1,678 | 977 |
| **2** | 1,970 | 1,370 | 3,940 | 2,360 |
| **3** | 1,101 | 834 | 3,303 | 2,411 |
| **4** | 584 | 705 | 2,336 | 2,722 |
| **5-9** | 764 | 1,077 | 4,647 | 6,625 |
| **10-14** | 128 | 345 | 1,478 | 4,161 |
| **15-19** | 54 | 138 | 894 | 2,332 |
| **20-49** | 44 | 166 | 1,225 | 4,628 |
| **50 or more** | 22 | 55 | 16,127 | 31,310 |

* These figure refer to NACE 521 and include department stores.
** Number of persons engaged includes proprietors and family members not paid a regular wage/salary.

Source:Central Statistics Office

Figures contained in a Department of Enterprise, Trade and Employment report (July 1998) show that the biggest share of the multiples grocery market is held by the Symbols Group (Mace, Spar, Super Valu, Londis, Centra, etc.) at 27.8% of the market. This group works by franchise, with the franchise holder buying for the group and providing support services – including marketing, technology and store design – to the independent retailers. Tesco occupies second place with 24.8%. The market shares for the other multiples stand as follows: Dunnes Stores at 21.6%, Superquinn at 7.9%, Roches Stores at 1.8% and Marks & Spencer at 1.0%. The balance is accounted for by small retail outlets which have 15.1% of the market between them.

## FORCES DRIVING CHANGE

### *ECONOMIC GROWTH*

The Irish economy has displayed very strong growth in recent years and since the late 1980s has transformed itself from what has been described as the “poorest of the rich” to “Europe’s shining light”[1]. The 1997 National Income and Expenditure accounts show that growth in GNP between 1991 and 1997 averaged 6.3%. Much of this has occurred since 1993.

[1] *The Economist*, January 16th 1988 and May 17th 1997

The CSO produces a Retail Sales Index on a monthly basis showing both the value and volume of retail sales. One of the sub-sectors included is the grocery sector, broadly corresponding to NACE 521 in the Annual Services enquiry. It shows that, between 1990 and 1997, the value of sales in the grocery sector grew by an annual average of 6.2%. This compares with an annual average for all businesses of 5.4%.

***INFLOW OF FOREIGN MULTIPLES***

One of the by-products of our strong growth has been an increased interest in the Irish market on the part of UK retailers. Boots, HMV, Debenhams, Virgin, Body Shop and Next, among others, have all established a presence here. The new Liffey Valley centre in west Co. Dublin includes the first C&A department store in Ireland. In the retail grocery sector Marks & Spencer and Iceland have established their own stores. Tesco opted to take over the Quinnsworth and Crazy Prices chain of supermarkets owned by Associated British Foods in May 1997. A number of other UK grocery retailers, including Safeway and Sainsbury, are interested in directly establishing themselves in the market or are looking to take over an existing operation here.

The arrival of Tesco is considered to be one of the main factors that will drive further change in the marketplace. According to RGDATA, the representative organisation for independent, family- owned grocers, Tesco is four times larger than the entire Irish grocery market and 18 times bigger than its nearest Irish supermarket competitor. Interest on the part of foreign multiples is not confined to UK sources. Germany's Lidl, a major price discount grocery chain with competitive pricing on non-food items also, is one such source.

***SUPERSTORE DEVELOPMENT***

The arrival of the Tesco chain has brought to the fore the issue of superstores – generally large out-of-town developments owned and managed by one retailer who provides a wide range of services to customers. In the UK this can include financial services and petrol retailing. Among other factors, increases in rents here for premium high-street or town-centre locations could lead to a shift to out-of-town premises, similar to the experience in the UK some years ago. Tesco has considered developing a superstore in Malahide, Co. Dublin, for example, and the new Liffey Valley centre contains the first out-of-town Marks & Spencer store.

RGDATA is strongly opposed to the development of superstores, arguing that they are not in the best interests of consumers as they will lead to reduced choice and competition. Furthermore RGDATA believes "that the introduction of the Superstore concept in Ireland will have serious negative consequences for planning and development in Ireland" and claims that the UK superstores have left over 40% of towns and villages there without a shop.

The widespread development of superstores has been stalled for the present. On June 9th, 1998, the Minister for the Environment and Local Government announced that a study would be undertaken on the implications of large-scale retail shopping developments with a view to preparing comprehensive planning guidelines. Pending the completion of the study, the Minister has introduced a Regulation that limits the size of supermarket developments to 3,000 square metres of retail floor space. The study will also focus on the wider implications of superstores for existing retailers and communities, urban areas and the impact on road traffic.

While the low population densities outside of Dublin would most probably limit the opportunities for out-of-town, superstore developments, their arrival would have a number of implications, as follows, for the retail grocery sector.

- Superstores would introduce centralised distribution systems and would benefit from the economies of scale that go with them. Of course, consumers would only benefit where cost savings were passed on in the form of lower prices.
- Even in the absence of centralised distribution systems, Irish-owned retailers will face increased competition as large foreign multiples exercise their purchasing power. Superquinn, for example, have already taken steps to overcome this particular threat by joining an international buying group.
- Superstores would increase competition within the sector. However, this may not be a positive development for the consumer. As superstores are usually operated by a single retailer that generally promotes own-brand products, the consumer may actually experience a reduction in variety and choice.
- One of the attractions for consumers of the superstore development is the availability of free parking, particularly at a time when traffic congestion is making city centre parking increasingly difficult. Yet, the need to use a car to travel to these centres gives rise to increased traffic volumes and to problems of a wider economic nature.

### *DEMOGRAPHIC AND LIFESTYLE CHANGES*

Changes in the demographic situation in Ireland have resulted in an increase in the proportion of the population in the 25-44 age group from 22% in 1973 to 27% in 1994. Analysis in the last ESRI Medium-Term Review (1997) suggests that shifts in the composition of consumer expenditure have occurred over that period. The proportion of household expenditure devoted to food fell by almost ten percentage points from 31.9% in 1973 to 22.7 % in 1994/95. The increased proportion of young people in the population means that tastes within the typical household can be held to have changed. This also explains the increase in resources devoted to expenditure on services, which include leisure activities and dining out.

There has also been dramatic change in lifestyles. Working hours have been extended and have become more irregular. At the same time, customer expectations of service and quality have increased. Retailers have had to make shopping more convenient for the customer through the development of convenience stores, retail outlets at petrol forecourts, Sunday trading and the introduction of 24-hour opening by multiples around Christmas. This latter is now a feature of the UK market and the growing presence of UK multiples this side of the Irish sea may mean that it will become a more regular feature here.

The majority of RGDATA members trade in smaller convenience stores and petrol forecourt outlets, either independently or as a member of a symbol group. RGDATA claim that its members currently service 45% of the £4 billion retail grocery market in Ireland. Refurbishment, a broadening of product ranges to include, for example, in-store bakeries, delicatessens or off-licences, as well as longer opening hours (some 24-hour) now better enable these convenience stores to compete with the large multiples.

***ELECTRONIC PAYMENT***

Technology is moving at a rapid pace. Already it is possible to shop on the internet. As use of this facility increases, the retail grocery trade may need to fully embrace this new technology in order to protect its customer base. A move away from paper towards personal electronic payment methods is clearly evident, one that is expected to gather momentum since the arrival of the euro. Laser cards, which were introduced here in 1996, are continually increasing in popularity among consumers as a replacement for cheques. The Ennis pilot project, which is using the country's first 'electronic purse' card, is further evidence of the shift from paper to electronic payment and of the challenges and opportunities that are facing the retail sector in this area.

## CHANGEOVER TO THE EURO

In common with all other business the retail grocery sector must prepare for and deal with the arrival of the euro – in non-cash form since 1st January 1999 and in cash form from 1st January 2002.

While the three-year transition period will allow retailers to adjust to the new currency, the period at the beginning of 2002 when both the national currency and the euro will be in circulation will be a difficult time. Retailers will have to cope with two sets of notes and coins, with corresponding security and insurance implications. The dominance of cash transactions means that the sector will be to the fore in assisting in the withdrawal of Irish notes and coins. This will place retailers at the 'front line' of the changeover. The resulting responsibility means that staff will have to be fully trained to deal with queries from customers about the euro, about prices and the conversion process; quite apart from the training that will have to take place to deal with the changeover process within the business itself.

The sector must also consider the issue of pricing in the euro. Given the fixed conversion rate of 1 euro = 0.787564 Irish pounds, euro prices will look higher than those denominated in Irish pounds. The euro will, therefore, have a major impact on price points. The price point of 99p has become €1.26 and retailers will need to reassure customers that the higher euro price, compared to the Irish pound price, does not signify that there has been an actual price rise. Nor does €1.26 have the marketing impact of 99p. It may be appropriate to change the size of some products so that their price in euro can contain the all-important figures '99'. To avoid significant price differences emerging in this way when euro prices are introduced, retailers should consider using the transition period to bring existing prices towards new euro price points. However, this could mean that certain prices in Irish pounds would not be at attractive price points for a short time during transition.

At the same time the euro will mean pan-European price transparency, resulting in a further increase in competition between retailers with consumers able to compare prices across the euro zone. While price transparency impacts on the retail operation of the grocery trade, it may also provide some opportunities in purchasing decisions. Irish-owned retailers now operate in a single currency environment that includes ten other countries. The fixed exchange rates between participating currencies may encourage retailers to source increasingly in other EMU countries.

## OUTLOOK FOR THE SECTOR

At present, economic growth seems set to continue. ESRI forecasts suggest that the average growth rate for GNP will lie around 6% for the period 1995-2000. Annual average growth will slow to around 5% a year in the following five years with some further deceleration thereafter. The return to rapid growth in the mid-1990s has resulted in a strong increase in employment levels. Current ESRI forecasts anticipate a further sustained increase in employment in the period to 2005. It is expected that this growth will be strong enough to absorb all labour market entrants and thus a continuation of the decline in unemployment is forecast.

Personal consumption of goods and services, as measured in the National Accounts, has displayed very strong growth in recent years, averaging 4.9% in real terms between 1991 and 1997. The value of food consumption, again as measured by the National Accounts, increased from £2.9 billion in 1991 to £3.7 billion in 1997, an increase of nearly 26% (Table 3). In 1997 expenditure on food alone accounted for 47% of expenditure on food, beverages and tobacco, and nearly 15% of total personal consumption. The Medium-Term Review (ESRI) forecasts that the volume of overall personal consumption could continue to grow at an annual average rate of 4.7% between 2000 and 2005.

**TABLE 3: PERSONAL CONSUMPTION, £M**

| | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 |
|---|---|---|---|---|---|---|---|
| **Food, beverages and tobacco** | 5,699.5 | 6,192.7 | 6,362.2 | 6,790.6 | 7,106.4 | 7,492 | 7,827 |
| **of which:** | | | | | | | |
| ***Food*** | 2,921.9 | 3,157.6 | 3,287.5 | 3,422.4 | 3,463.0 | 3,558 | 3,667 |
| ***Non-alcoholic beverages*** | 195.9 | 269.8 | 226.6 | 237.6 | 257.9 | 289 | 309 |
| ***Alcoholic beverages*** | 1,888.3 | 2,036.2 | 2,112.8 | 2,327.3 | 2,477.9 | 2,739 | 2,876 |
| ***Tobacco*** | 693.4 | 729.1 | 735.3 | 803.2 | 907.6 | 906 | 975 |
| **Non-food** | 11,114.5 | 11,854.5 | 12,457.2 | 13,763.3 | 14,734.1 | 15,995 | 17,364 |
| **Total** | 16,814.0 | 18,047.2 | 18,819.4 | 20,553.9 | 21,840.5 | 23,487 | 25,191 |

Source: CSO National Income and Expenditure, 1997

Against this background of continued growth in the economy, the following features are likely to apply to the retail grocery sector.

- The ESRI Medium-Term Review contained a number of demographic projections. These point to a continued increase in the numbers within the 25-44 age cohort which is forecast to account for 28% of the population by 2001. At the same time, Ireland is expected to enjoy a decline in the dependency ratio. Since the 1960s, the Irish economy has had to cope with economic dependency levels that were exceptionally high. At the peak of economic dependency in the mid-1980s, there were nearly 230 dependants for every 100 workers. The projections suggest that the dependency ratio will decline until about 2010 when it will have fallen to 125 dependants per 100 workers. The number of households is expected to rise from 1.1 million in 1996 to 1.4 million in 2006 and 1.5 million in 2011, with an associated fall in the number of adults per household as more young adults set up their own household. The demographic outlook therefore appears to be favourable for the retail grocery trade. The decline in the dependency ratio should lead to higher levels of disposable income while the increasing number of households should fuel demand.

- The buoyancy in the economy and the strength of personal consumption has meant that the proposed minimum wage, to be introduced in April 2000, will be largely irrelevant for the sector. Current labour shortages have pushed existing wage rates above the proposed minimum level. However, an economic slowdown after April 2000 would require the sector to be flexible while at the same time meeting the requirements of the minimum wage. Loss of flexibility in wages means adjustment would be necessary in other areas, leading to some consolidation within the sector.

- The current labour shortages that arise from strong job creation in a rapidly growing economy have resulted in a change in the age profile of labour within the retail grocery sector. Difficulties in attracting young personnel have led a number of the multiples to actively recruit older staff in an effort to fill existing vacancies.

- One of the main factors that will shape the outlook for the sector, the development of superstores, is currently on hold. The recommendations of the study, referred to earlier, will determine much of the change that will occur in the future. If the development of superstores is permitted, it will have implications not only for retailers but also for producers, suppliers and consumers. Competition will increase as independent retailers, town-centre multiples and out-of-town superstores all compete for customer loyalty and market share.

- The trend will be towards increased competition between all the multiples. This is likely to intensify if more large foreign multiples enter the market, particularly those in the price discounting segment. The multiples and the independent retailers will continue to do battle for the weekly shopping basket, but the latter may find themselves under more pressure to cater for the convenience ‘top up’ section of the market by opening longer hours. Increased competitiveness should result in greater promotion of and emphasis on loyalty cards, as used already by Superquinn, Dunnes Stores and Tesco.

- An increasing emphasis on own-brand is also anticipated. Own-brand is comparatively underdeveloped in Ireland at present and there is a perception that own-label goods are in some way inferior. However, the increasing number of UK multiples operating here is expected to lead to a further drive in favour of own-label goods that offer the retailer a higher margin. Tesco Ireland has already put its marker down in this regard, by outlining to the Department of Enterprise, Trade and Employment in March 1998 its plans to add a further 90 Irish-made Tesco brand products to the 60 already available.

- Increased diversification by the retail grocery multiples is likely. A trend that has emerged in the UK is the provision of banking services by some of the leading multiples such as Marks and Spencer, Sainsbury, Safeway and Tesco, as well as the stocking of non-food items such as videos, CDs and books. While such diversification is not in evidence here yet, it could well emerge as the sector becomes increasingly competitive and the multiples look for more ways of differentiating themselves and attracting customers. This would have obvious implications for retailers outside as well as inside the grocery trade.

The above features point to a sector that has changed dramatically in recent years and will continue to experience change. A continued inflow of foreign multiples, the outcome of the superstore study and developments in technology and internet shopping will shape the sector in the years to come. One thing is certain – the retail grocery sector will remain highly competitive.

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