Managing surplus cash in a new Irish economy

Pat Leavy of FTI looks at 20 years of changes in the Irish economy and how Emu entry has forced companies to re-evaluate their approach to cash management.

The past 20-year period has seen dramatic changes in Irish economic conditions and circumstances. In 1979, Ireland joined the exchange rate mechanism (ERM) of the European monetary system (EMS) with the intention of improving monetary stability, while moving to a low inflation, low interest rate environment. The result of this move was that the Irish pound broke its parity relationship with sterling for the first time in more than 150 years. At the time, Irish three-month interest rates were hovering at around the 15% mark.

Ireland and Emu

Ireland remained a member of the ERM from 1979 until becoming a full participant of Emu on 1 January this year. It could be argued that, over this 20-year period, Ireland did not reap many of the benefits that it had hoped for from ERM membership, particularly regarding the convergence of Irish and German living standards and interest rates. Ireland's close economic relationship with the UK was a significant determining factor in this instance. The Irish punt was devalued in 1983 and again in 1986 to restore competitiveness due to sterling depreciation and to reduce pressure on domestic money market rates. Sterling withdrawal from the ERM in 1992 resulted in unprecedented high interest rates in Ireland over a six-month period (in the period from September 1992 until February 1993) until the Irish punt followed the inevitable depreciation route.

The period 1979 to end-1998 saw Irish three-month money market rates range between 5% and 25% (excluding the currency crisis of early 1993) with an average rate of 10.5% over the period. This compared with German three-month rates ranging between 3% and 12% (averaging 6.04%) over the same period. This is illustrated in *Figure 1*.

Clearly, the economic landscape in Ireland has changed significantly with a new currency and a changed interest rate environment

With the advent of Emu at the beginning of this year the interest rate differential between Ireland and the ten other members of Emu disappeared. The Irish Central Bank opted to wait until the last possible moment before reducing Irish rates to European levels in Q4 1998.

The Irish economy now finds itself with its lowest ever interest rate environment. Most importantly, the expectation of similar high interest rates as in the past has disappeared, due to historically lower levels of interest rates in Europe. Ironically, the current low level of euro interest rates is not suitable to current booming Irish economic conditions and tighter monetary policy would be more appropriate.

Pat Leavy

Ireland remains Europe's fastest-growing economy after seven years of a record expansion. The Irish Central Bank forecasts that GDP will expand 7.5% in 2000, consumer prices are currently rising at 1.75%, unemployment is under 6% and falling and the budget surplus is expected to rise to 3% of GDP this year.

With the European Central Bank now responsible for monetary policy, Irish authorities no longer have access to this tool as a means of smoothing economic performance. Indeed, Irish GDP represents only 1% of euro-land GDP, suggesting that Ireland will have little influence over European monetary policy which will be dictated by the large-core economies. Fiscal policy will play a crucial role, while increased emphasis will be placed on wage restraint to remain internationally competitive. Ensuring moderate wage increases and tight fiscal policy will be a significant challenge given the prevailing buoyant economy and swelling public coffers.

Clearly, the economic landscape in Ireland has changed significantly with a new currency and a changed interest rate environment. With the economic debate regarding Emu participation subsiding, the job of managing its consequences must now be undertaken. The implications for the corporate treasurer of managing surplus cash in a low interest rate environment is today considerably different to the historical precedent.

Investment alternatives

Traditionally, Irish corporates invested in the standard range of interest-bearing instruments: bank term deposits, wholesale money market deposits, bank CDs, Irish government exchequer bills and

FIGURE 1

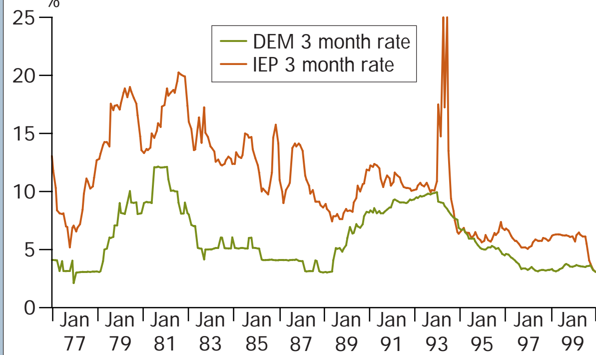
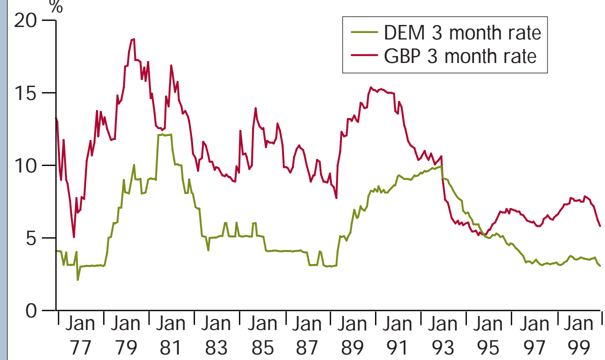


FIGURE 2



gilts and in a very limited commercial paper market. New investment opportunities have been driven by two factors, the re-denomination of the Irish punt as the euro and by the response by financial institutions in developing and providing new products.

The change of currency now offers the scope to invest in a large liquid euro-commercial paper market and euro-bond market without attracting currency risk. This represents significant change and opportunity for Irish investors who, in the past, suffered severely from illiquid markets. It also offers the opportunity for financial institutions to use derivatives in a liquid currency as a basis for offering new products.

Up until now, the development of derivatives was limited by the illiquidity of the Irish punt. The first wave of such products can be generically described as interest at risk instruments. They seek to achieve enhanced returns by risking part or all of the interest income amount. The capital is guaranteed. For example a corridor deposit takes a view on the stability of a given index, typically Euribor. An enhanced return is received for each date that the rate is within a specified range. A further example is a knock-in deposit which allows the depositor to enhance his or her return by taking a view on the future path of any given index – essentially an option based on a futures contract which offers an all-or-nothing payoff.

In addition, there has recently been a significant development in equity-based investment instruments, ranging from products with different degrees of capital at risk to products with different share choices. They now offer an investment opportunity anywhere along the risk/reward continuum. These equity-based instruments are packaged in a dangerously luring way for the unwary corporate treasurer. The consistent out-performance of equities over bonds and cash is well documented – typically four and a half times greater over the past five years.

Challenges

The pressure to consider capital at risk investment instruments in particular has increased and is being considered seriously by some companies.

This challenge has raised some fundamental issues for Irish companies. Existing policies, risk philosophy, performance measurement and alternative products are under consideration. Shareholders want returns on capital rather than low returns on cash and, significantly, it is the efficient use of cash that is under review at the highest levels in organisations in terms of capital investment, acquisitions and share buy-backs. However, surplus cash amounts exist and as a result treasurers in Ireland are seeking to ensure that a revised and up-to-date clearly defined investment policy is in place, the implications of which are well understood by senior management and their board.

> Ensuring moderate wage increases and tight fiscal policy in Ireland will be a significant challenge given the prevailing buoyant economy and swelling public coffers

The company's risk appetite is being tested and a more active approach is being considered by some. This varies from looking to playing the yield curve, which until recently offered limited potential, to trading futures contracts for a known exposed amount.

The robustness of performance measurement benchmarks has also been challenged. In some cases benchmarks are currently being critically reviewed and updated where and if necessary.

There is now a wider choice of counterparties available on a European-wide level who provide euro-denominated products and services. This also is coming under scrutiny.

Hence, the challenge for treasurers to recover 'lost' returns continues and has resulted in increased attention being focused on surplus cash management.

Relevance for the UK

While the jury is still out on UK membership of Emu, *Figure 2*, which compares GBP three-month Libor to three-month deutschemark/euro money market rates, suggests that a similar experience of moving from a higher to a lower interest rate environment could occur from a UK perspective.

Emu has forced Irish companies to re-evaluate their approach to surplus cash management and much of this is taking place after the event. Arguably, it shouldn't have to take such an event for a reappraisal to occur and there is an opportunity for UK companies to consider the implications of such an event on their own practices in advance. ■

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