HOUSES OF THE OIREACHTAS

Volume 1 **Number 7**

AN COMHCHOISTE FIOSRÚCHÁIN I DTAOBH NA GÉARCHÉIME BAINCÉIREACHTA

JOINT COMMITTEE OF INQUIRY INTO THE BANKING CRISIS

Dé Céadaoin, 11 Feabhra 2015

Wednesday, 11 February 2015

The Committee met at 9.30 a.m.

MEMBERS PRESENT:

Deputy Pearse Doherty,	Senator Sean D. Barrett,
Deputy Joe Higgins,	Senator Michael D'Arcy,
Deputy Michael McGrath,	Senator Marc MacSharry,
Deputy Eoghan Murphy,	Senator Susan O'Keeffe.
Deputy Kieran O'Donnell,	
Deputy John Paul Phelan,	

DEPUTY CIARÁN LYNCH IN THE CHAIR.

Context Phase

Professor John FitzGerald

Chairman: The committee is in public session. Today we will hear from Professor John FitzGerald on issues relating to the international, EU and domestic policy context for the banking crisis in Ireland, and in particular the ESRI's medium-term reviews in the years prior to Ireland's banking crisis. I welcome everyone to the eighth hearing of the Joint Committee of Inquiry into the Banking Crisis. Professor FitzGerald is very welcome to the inquiry.

Professor John FitzGerald: Thank you.

Chairman: Professor John FitzGerald has been a research affiliate at the ESRI since November 2014. Prior to that he was a research professor at the ESRI and programme co-ordinator of the macro-economics research area. He is president of the Association d'Instituts Européens de Conjoncture Économique and a former president of the Irish Economic Association. He is presently a member of the commission of the Central Bank of Ireland and of the independent expert panel established in 2014 by the Department of Communications, Energy and Natural Resources.

Professor FitzGerald has published in a number of different fields. In collaboration with his colleagues in the ESRI, he helped develop the ESRI's macro-economic modelling programme. He was a joint author of the report for the Department of Finance on the economic implications for Ireland of the EMU which was published in July 1996. This report was central to the debate on Ireland's membership of the EMU.

He is a joint author of the ESRI's medium-term review which provides a detailed analysis of Ireland's economic prospects over the next decade. In 2011 John FitzGerald was admitted as a member of the Royal Irish Academy in recognition of his work on the behavioural characteristics of the Irish economy.

I advise that by virtue of section 17(2)(*l*) of Defamation Act 2009, the witness is protected by absolute privilege in respect of his evidence to the committee. If he is directed by the Chairman to cease giving evidence on a particular matter and continues to do so, he is entitled thereafter only to a qualified privilege in respect of his evidence. The witness is directed that only evidence connected with the subject matter of these proceedings is to be given and, as he has been informed previously, the committee is asking him to refrain from discussing named individuals in this phase of the inquiry. I remind members of the long-standing ruling of the Chair to the effect that they should not comment on, criticise or make charges against a person outside the House or an official by name or in such a way as to make him or her identifiable.

I invite Professor FitzGerald to make his opening statement.

Professor John FitzGerald: I thank the Chairman and thank him for the invitation to appear.

I should say at the beginning that I speak for myself and I do not speak for the ESRI. I will attempt to respond to the questions, which I was asked, on a range of economic issues.

Over the period 2001-07, in a wide range of publications, together with my colleagues, we repeatedly warned about the dangers posed for the Irish economy by the growth of a property market bubble and of the need to use fiscal policy to defuse the situation. If the advice on fiscal policy had been followed, Ireland would probably have escaped much of the damage that was suffered over the recent crisis. However, we did not draw the connection between the growth of a property market bubble and the risks to the financial system. In 2008 in our medium-term review, we failed to foresee the impending financial collapse. The review had a short shelf life because six weeks later we published the quarterly economic commentary which carried headlines that Ireland was in recession. I am afraid its shelf life was short.

I was asked questions about the economic recovery of the 1990s. Having spent the 1980s dealing with a major budgetary crisis, the economy entered a period of rapid growth in the 1990s. The ground had been prepared by a very substantial improvement in competitiveness and the restoration of order to the public finances in the 1980s.

There were a number of underlying strategic factors in the Irish recovery. These included the completion of the EU Single Market which was particularly important for us at the end of 1992. In addition, there was the effect of investment in education, because Ireland had lagged behind the rest of northern European for a long period. Finally, the rising participation of women in the economy was important. These factors helped to produce a sustained rapid period of growth in the 1990s.

Due to the fact that growth was fuelled from outside of Ireland, it resulted in a substantial movement into a current account surplus of the balance of payments. That meant that savings were enough to fund investment. We did not need a capital inflow to the banking system to fund the very rapid growth because we were living within our means.

A significant part of the growth of the 1990s represented a catch up on the rest of the EU 15. There is an interesting article by Cormac Ó Gráda which was published in the ESRI's quarterly economic commentary which brings this matter out. The interesting thing about Ireland was that bad policy, over a very long period, managed to keep us down. Then we had a recovery in the 1990s which acted as a catch up to probably where we should have been otherwise.

By the end of the 1990s, and into the first few years of the 2000s, the catch up phase was completed and the rate of productivity growth slowed rapidly. While exports continued to grow, domestic demand began to rise quite fast. People reacted to their higher living standards by spending more on consumption and, in particular, investment in housing. This rise in domestic demand was further fuelled by stimulatory fiscal policy which going back to the medium-term review of 1999-2001, and so on, we felt was unwise and a fueling of an already very rapidly growing economy. Rising expectations saw a gradual disimprovement in competitiveness due to wage inflation which adversely affected exports. The current account of the balance turned negative. I expressed serious concerns about the nature of fiscal policy, in particular in 2001, but it was probably only in 2003 that growth really began to outstrip the potential of the economy, giving cause for real concern. The bursting of the dotcom bubble in 2002 took the steam out of the economy, which we were worried about in 2001, and that postponed the turning point.

I was asked to say something on the external policy environment. With the advent of monetary union in 1999, the ECB took over control of monetary policy so that interest rates were not set to meet the needs of individual economies. They were set as they are today to meet the needs not of Germany but of the EU economy as a whole. Monetary union also facilitated the free movement of capital, as anticipated. It reduced the risk premium, which is the cost of capital. In the 20 years between 1979 and 1999, Ireland paid 2% more on average than Germany, controlling for everything else. There was a risk premium which meant investment was more expensive. We were less competitive than Germany. That risk premium disappeared with monetary union. Prior to monetary union, Ireland and Spain had probably under-invested in housing as we had a higher cost of capital than in countries like Germany or France. Given the demographic profile, we needed to invest in housing. In permitting a more rapid adjustment to the housing stock, the lower cost of capital was beneficial. However, it was the failure to appropriately control this surge in investment which eventually proved fatal.

Monetary union had its benefits, but it required governments to act differently. In our case and in the case of Spain, governments did not act differently. When the property boom got out of control in the period 2003 to 2007, the intensity of the investment went well beyond domestic savings and the counterpart to the deficit was the inflow of funds through the banking system. The demand for credit to fund investment ran well ahead of the ability of the banks to meet from their own domestic funds. However, it proved easy and cheap to borrow additional funds abroad. In the period before monetary union, a constraint on such expansion might have been the exchange risk involved in such borrowing but the experience of EU countries outside monetary union shows that a change in the world economy had taken place. This was partly due to US policy and meant that cheap money was available not just because of monetary union. Estonia and Latvia were not members of the eurozone, but they suffered exactly the same experience of a massive property bubble fuelled by very large investment through the banking system of very cheap money. One should not blame monetary union as it was a worldwide phenomenon of cheap money which governments and central banks failed to manage appropriately.

The turning point was 2003, but one can argue about it. The current account of the balance of payments was in deficit that year, though the size was small, but wages had been rising rapidly for a number of years and the loss of competitiveness was beginning to take a toll, notwithstanding that it was not yet that serious. House prices in 2003 returned to growth at more than 10% a year and the demand for credit was outstripping the ability of the banks to fund it. One began to see the banks borrowing abroad in the inter-bank market to fund the expansion of credit. The demand for housing, however, had a real basis in terms of the rising population. House completions at nearly 70,000 were running ahead of the actual increase in population and there was no sign of the rate of increase in house prices slowing. An important factor driving that was what I call the "user cost". People expected house prices to rise in future which made buying a house much better than renting because rents would go up. That proved self-fulfilling and produced a bubble effect. Over the period to 2007, the current account deficit ballooned reflecting the fact that domestic savings were not enough to fund the investment boom. We had to borrow from abroad, which resulted in increasing vulnerability for the banking system and a rapid rise in household indebtedness.

It is impossible to identify when the bubble became irreversible. The last chance to stop it without disaster was probably in 2006. By the end of that year and moving into 2007, house prices were far above their equilibrium level and collapse became inevitable. I have provided the committee with a detailed appendix which I will not go through here. It shows that the dangers were apparent, even if disaster was not certain. One further factor which aggravated the cost of the collapse was the fact that the building and construction sector was like a tumour which grew and grew, squeezing the rest of the economy. Fortunately, it turns out not to have been cancerous and we are getting over it. However, real jobs were squeezed out in the rest of the economy. This contrasts with the situation in the UK, which also had a property bubble. However, they did not allow any building so that when prices collapsed, there was not a collapse in a large part of the economy. The expansion of the building sector in Ireland meant that it had to bid resources away from the rest of the economy. This was done through inflation which made the rest of the economy uncompetitive. This killed off a significant number of firms and jobs in the exporting sector. These jobs did not seem important at the time and nobody noticed they were going in the absence of news headlines, but they have proved crucial. We really need those jobs today.

I turn finally to the policy response. The dangers the economy faced as a result of the over-inflation of house prices, the build-up of debt and the loss of competitiveness in the economy were foreseeable and foreseen. The build-up of the bubble could have been prevented by appropriate fiscal policy or by appropriate prudential action by the Central Bank and the regulator, or both. Either one of these policy instruments, if appropriately deployed, could probably on its own have prevented disaster. Both together would have prevented disaster. On fiscal policy, I note that from 2001 onwards in many publications, I and my colleagues pointed to the need to tighten fiscal policy. Instead, in an economy that was growing strongly and well above potential, fiscal policy pumped money into the economy in six out of eight budgets. There is a graph which shows this. When the economy was growing rapidly, successive Governments pumped money into it, which greatly aggravated the situation. If instead the Government had run a deflationary fiscal policy, as we recommended repeatedly, and built up a substantial surplus, it would have taken the steam out of the housing market and reduced pressure on the labour market. The case of Finland is instructive. Having experienced the same disaster we did only 20 years earlier, it ran up a current government surplus of 5% to prevent a repetition.

In addition to operating a much tighter fiscal policy in the 2001-07 period, I recommended using specific fiscal instruments to take the heat out of the building and construction sector. We recommended getting rid of all building incentives and, possibly, taxing mortgage interest payments. The UK Treasury visited us and published a paper in 2003 which said that if the UK joined monetary union it would need to use fiscal instruments to manage the housing market. The Treasury recommended using stamp duty, but the problem with that is it would lead to higher household debt. My feeling was that taxing mortgage interest payments would discourage people from taking on debt. As people would end up with lower debt, it would be a better instrument. Either way, one could have used fiscal instruments to take the heat out of construction. A further result would have been a smaller balance sheet in the banking sector. If the building sector had not been allowed to grow and fewer houses had been bought at lower prices, the banking sector would not have been vulnerable.

I will not go into banking regulation and macro-prudential policy in detail. It was the other instrument which could have been used. There were a range of ways the Central Bank and the regulator could have stopped the growth in credit, as demonstrated by research from within the Central Bank itself by Kieran McQuinn and Gerard O'Reilly. They wrote a number of papers on how credit growth is important in fuelling house prices. If the credit channel had been choked off in 2003 to 2007 by the regulator, it would have halted the rise in house prices or, at least, achieved an appropriate moderation. Policy instruments were available.

By 2007, it was probably too late to prevent a major crisis from occurring in 2008. However, if urgent action had been taken in the form of a tightening of fiscal policy or regulatory action, it would have reduced the subsequent damage. It would have reduced the indebtedness of the household sector by stopping the boom earlier. If people who bought in 2007 had not bought, they would not be in difficulties today. The bloated balance sheets of the banks would have been smaller. However, if policy makers ever considered such action, which I do not think they did, they might have decided that bursting the bubble deliberately in 2007 or early 2008, with serious consequences, was much less attractive than hoping for redemption by delaying action. It became politically difficult even at the best of times to take action once things had gone that far. If any action had been taken in 2007, it would probably have left a smaller problem to be dealt with.

Chairman: Before I turn to our lead questioners, Deputy Pearse Doherty and Senator Michael D'Arcy, I will do some scene setting with Professor FitzGerald to provide some clarity on the role of the ESRI and its relationship with the Department of Finance. The ESRI is often described as the Government think tank. Is this an accurate description? Will Professor FitzGerald describe the ESRI's functions, how it is funded and the nature of its advisory role to the Government?

Professor John FitzGerald: The ESRI was founded in 1960 to provide independent advice to the Government. Professor Joe Lee in his *Ireland, 1912-1985: Politics and Society*, commented on the fact that universities were not producing useful research at the time. It was an initiative led by Dr. Ken Whitaker, the then Secretary of the Department of Finance. To guarantee its independence, he sought funding for it from the Ford Foundation. He told me that he discovered that the person responsible for funding in the Ford Foundation served mass in a church in New York. He went to mass and nobbled him after it to get the money for the ESRI. For the first four years, it was totally independent of the Government. That was the intention of both the Government and the Secretary of the Department of Finance.

The ESRI is legally a charity. The Department of Finance took over giving it 100% funding when the Ford Foundation money ran out in the middle 1960s. The ESRI was about 80% funded by a direct grant from the Department of Finance until the late 1980s. Then there were pretty dramatic cutbacks, as we know, and the ESRI chose to survive by looking for research contracts from the EU, other Departments and so on. Today, approximately 30% of its funding comes from grant-in-aid from the Department of Public Expenditure and Reform with the other 70% coming from a range of sources such as public research funding from the EU, SFI, Science Foundation Ireland, Departments and public bodies, with a limited amount from the private sector. The ESRI insists on publishing everything it does without censorship. The private sector is not generally prepared to fund public good research.

The ESRI is governed by a director who is responsible to a council. The council is not appointed by the Government but co-opts its membership. Until the late years of the last decade, the Secretary General of the Department of Finance was always a member of the council. It is now an assistant secretary from the Department of Public Expenditure and Reform. The Central Bank Governor has generally been a member. There is a range of people broadly representative of civil society. The council is not appointed by the Government, a provision which is there to ensure its independence.

The Department of Finance has been party to these ground rules. Generally, it has been good to deal with. It understands we kick them and they grin and bear it. There are times when things have been less happy, however.

Chairman: Members of the committee will raise questions about the medium-term reviews from the ESRI. What is the purpose of these reviews? What was Professor FitzGerald's role in producing them?

Professor John FitzGerald: The first one was published in 1986 but I was not involved in that. Since 1987, I have been involved in these medium-term reviews. Initially with my colleague, John Bradley, through the 1990s we were jointly responsible for it. Since 1989, I have been the lead author but with other colleagues. It has been published every two or three years. It uses a range of tools to understand how the economy behaves and to look in a longer term context over several years at what are the strategic issues and how policy can produce a better outcome.

Reflecting the fact we do not know what the future is going to bring, we always publish a range of scenarios. This always poses problems for the media. We tried producing two scenarios and it asked if it was the higher or the lower. Then we tried producing three scenarios and it asked is it the middle one. The rest of the world has difficulty dealing with uncertainty just as we do. Since 1987, we have developed the Harmonised Econometric Research for Modelling Economic Systems, HERMES, model and have a range of other tools we use in undertaking the work.

Chairman: What is relationship between the ESRI and the Department of Finance in the publication of the medium-term reviews? Does the ESRI do this in co-operation with the Department? Is it through a request from the Department?

Professor John FitzGerald: It is totally independent and funded out of the grant-in-aid. It is quite an expensive process, costing approximately €250,000 or more in terms of resources. As it is funded out of the grant-in-aid, it means it would be impossible for the institute to publish one of these reviews every year. We were offered funding by a large bank in the late 1990s to sponsor it but we certainly rejected that. The review is independent of the Department of Finance.

Part of the quality control process in the ESRI is that it is reviewed by anonymous referees not involved in the institute. On policy relevant research, we tend to send it to interested bodies which could spot problems or come up with suggestions. We have always sent it to the Department of Finance and we always get comments back from it.

Chairman: Is it the ESRI which decides the final publication of the review?

Professor John FitzGerald: The Department of Finance has no role in that. We decide what we are going to do. Over the years, the Department has always had problems with it. The Department's comments come in two kinds. There are the really useful technical comments. Over 30 years, there are people in the Department who discover inconsistencies. There are very few other people outside who can do so and it is very useful. Then there are political comments. We know and they know they are political comments. We ignore them but they have got to say it. Over most of the past 30 years, the Department knew the ground rules and that we would ignore them. In the last decade, the Department became a little grumpier when we did not accept its political views. The ground rules are there in that it can say what it likes and we can say what we like.

Chairman: In his opening statement, Professor FitzGerald stated:

> With all ESRI reports, the conclusions in each report were the personal responsibility of the authors. They did not represent the views of the ESRI. The ESRI with all its publications operates a quality control process where the publications were vetted in advance by independent reviewers to ensure they met an appropriate academic standard.

Does this apply to the ESRI's economic quarterly commentaries and medium-term reviews? If that is the case, will he explain why these outputs did not represent the collective views of the organisation?

Professor John FitzGerald: Going back to its foundation, like a university, the institute did not want to be responsible for the views of its authors. There were various rows in the past about this, particularly in the 1970s. If the research is of academic quality and does not libel anybody, it will be published. It is like a university. The director or the council may not like what has been said in a report but it vindicates the right of the researcher to publish the results of his or her research which has been peer-reviewed and is of quality, even if they do not necessarily agree with it. For example, if a professor in Trinity College Dublin says something, the provost is not expected to answer for that. In the public mind, people believe the ESRI thinks. The ESRI does not think. It is its researchers that think. The ESRI corporately does not take responsibility but it does take responsibility for the quality of the research and that it stands up academically.

Deputy Pearse Doherty: In his opening statement, Professor FitzGerald stated he and his ESRI colleagues did not draw the connection between the growth of a property market bubble and the risks to the financial system and in the 2008 medium-term review, it failed to foresee the impending financial collapse. Given the ESRI's level of expertise in the Irish economy, why does he believe the financial risks due to the commercial and residential property bubble were not factored into its forecasts?

Professor John FitzGerald: First, the ESRI does not like to campaign. Instead, in both quarterly economic commentaries and medium-term reviews, we prefer to rely on research. We are uncomfortable with moving too far away from research. We had not done research on the financial sector since the late 1990s when Patrick Honohan left in 1998. Our area of expertise, one in which we had done a lot of research and are the experts, is fiscal policy. We concentrated on that channel. As I indicated earlier, if that channel had been operated properly, we would not have got into the mess.

We were conscious there were problems, however. I wrote to the Central Bank in February 2006 about an issue. I contacted it again in March or April 2007 about my concerns. If one looks at the 2007 April spring quarterly commentary, we did mention the financial risks. In addition, we mentioned this in papers back to 2004 in the Dublin Economics Workshop. While we were conscious they were there, because we had not done research, we did not go into detail on that. Looking back on it, had I even looked at the data on the balance sheet of the banking system, I would have known there was a major problem. I would not have needed a lot of research to conclude it was not just fiscal policy. I feel that I made a serious mistake in not looking at the data on that. I suppose a lot of people relied on the fact that the Central Bank had the biggest number of economists doing research. As they were doing research on that area, were we to go out seeking funding for such research, the response would have been the Central Bank was doing it. The lesson for the future is that there is a need for two people or bodies to undertake research on any given area. However, what happened is a cause of regret. It is not because we were told not to, rather it is why I did not look at the data, as it would have stood out. Even though we had not done research, I think I would have said something on it.

Deputy Pearse Doherty: In respect of research carried out and published by others in newspaper articles - Morgan Kelly is one who springs to mind for example - was such research simply ignored by the ESRI in its forecasts?

Professor John FitzGerald: No. I think the first discussion of what Morgan Kelly was producing was in September 2007. We were conscious of the fact there was a problem but made a call that Ireland probably would escape it. We were totally wrong. If we had known there would be a financial collapse elsewhere, then we would have known there was going to be one here. The way we operate when doing our forecasts is that we do not forecast for the rest of the world but take scenarios drawn up by the IMF, the National Institute of Economic and Social Research in London, the OECD or whatever and then plug them into the model. We plugged it in and as nobody expected a financial collapse, we therefore did not get one in Ireland. However, that is a cop-out. We should have seen the problem. As for Anglo Irish Bank, we may have discussed the problem at the quarterly editorial meeting in April of that year. One thing I learned is one does not say a bank is going to go bust or one will be sued for libel. However, that was not the reason. It was just that we concentrated on what we did well and did not open our eyes to a wider horizon. We then published in May but by June, it was clear that disaster was on the way.

Deputy Pearse Doherty: Was there a lack of expertise within the ESRI in respect of financial and banking matters?

Professor John FitzGerald: One would not have needed much expertise to know that there was a problem, were one to look at the data. However, we did not do research on the financial or banking sector. We had limited funding and on the macroeconomic side we had a long-standing specialism in fiscal policy.

Deputy Pearse Doherty: I appreciate the funding model as Professor FitzGerald has outlined earlier. However, the organisation or the authors of its reports did go on to draw firm conclusions. For example, in the 2008 medium-term review, its authors wrote:

> The fundamentals of the Irish economy are sound. Even if the immediate future may prove quite difficult, the resilience of the economy is such that, if properly managed, it is likely to return to healthy economic growth in the medium term.

That was published in May 2008. Can Professor FitzGerald explain to members what, in his view, were the fundamentals about which the ESRI was talking that were sound at that point?

Professor John FitzGerald: We were talking about the real economy that produces goods and services for export. Actually, on that, I think we were right. When the IMF came to town in late 2008 and in 2009, it said the economy was broken and would never recover. In particular, it stated that lasting damage would be done to the tradeable sector, that is, the export sector. Were one to plug in the right numbers in terms of the financial sector, the model we had of the economy actually explained what happened to the real economy and we can see the real economy is recovering now. However, what it did not see was the catastrophic damage done by the financial collapse, in which one had a dramatic fall in output. I believed then that the economy would recover from whatever happened and I think that actually is what is happening. Nevertheless, that does not excuse the fact that we did not see the financial collapse. We published an article in 2011 in which we considered how the economy's behaviour was in line with previous behaviour, if one put in the right external numbers into our way of understanding the economy. In an updated medium-term review in 2010, we published a high and low scenario for Ireland out to 2020 on the basis that the real economy was not broken and that the business sector would respond in a recovery. It actually now looks as though the outturn for the decade will be somewhere between our high and low projections from 2010.

Deputy Pearse Doherty: Let me simplify this. Does Professor FitzGerald stand by the statement of May 2008 that the fundamentals of the Irish economy were sound?

Professor John FitzGerald: No. The financial sector patently was massively unsound. The sector that produces goods and services was sound and has recovered. However, we know that the disaster has had a huge impact on the economy and consequently, not seeing the unsound nature of the financial sector was a bad mistake.

Deputy Pearse Doherty: Professor FitzGerald has told the committee the ESRI did not conduct research in areas of banking or financial institutions, yet it came to conclusions that suggested the fundamentals were sound. I assume Professor FitzGerald would suggest that a properly functioning banking system is one fundamental of the economy. Can he explain to the committee why the ESRI came to such a conclusion in May 2008, given what was happening and what was known about at that time, such as the share prices in banks, investor confidence and what the markets were saying? Why did the ESRI reach such a strong conclusion?

Professor John FitzGerald: There were two possible outcomes. One was if the world had a normal type of recession or slowdown and the other was if there was a financial collapse. The world not having a financial collapse was what all the forecasts we were using were suggesting. None of the major institutions on which we relied - we did not have expertise in that area - were suggesting a financial collapse when we put the thing to bed in March or April 2008 and we relied on that. While we did include a scenario in respect of liquidity constraint, it was much too mild. We should have seen there were two possible scenarios. However, in May, after the publication of the medium-term review, I attended a meeting of the organisation of which I now am president in Europe and what I heard there from the other economic institutes in Europe suggested things were substantially worse. There was a particular presentation by an economist from the National Institute of Economic and Social Research in London which looked at how a financial collapse in the United States could ramify to Europe and would have a much more dramatic impact. Immediately after the publication, I became aware that the rest of the world was contemplating matters being much worse and then, six weeks later, in a quarterly economic commentary, we stated we thought there was going to be a recession and that it was clear we were wrong. We took numbers from outside which proved to be massively wrong and relied on them and did not contemplate the other outcome, which unfortunately, we now know happened.

Deputy Pearse Doherty: Earlier on, Professor FitzGerald mentioned the ESRI publishes everything it does without censorship. In July 2000, *The Irish Times* reported that changes to a draft of the medium-term review were requested by an unnamed official in the Department of Finance. These were in respect of strong criticisms made of then proposed single regulatory authority. In 2003, *The Irish Times* again reported on perceived Government influence on the medium-term review of the national development plan, stating that a recommendation to the effect that spending on the national road programme be left unchanged was replaced by a recommendation that it be increased. Can Professor FitzGerald outline to the committee whether unnamed officials within the Department of Finance, for example, in respect of the 2000 report, requested changes to the medium-term review? Were such requests acceded to?

Professor John FitzGerald: I was just told about this last night and so have not checked the ESRI's records. However, I have checked my own records and refer to the period between 27 September and 2 October 1999. On behalf of the United Nations climate change commission, I was in Warsaw to examine Polish compliance with the climate change protocols. I was telephoned by the director of the institute while I was in Warsaw to say that the Department of Finance had been jumping up and down about a particular article. I discussed it with the director and it seemed to me that the Department's comments were political and should be ignored. I checked this and note that the first set of chapters of the medium-term review were finalised, on my machine in any event, on 1 October 1999. Some time between then and 15 October, we published the medium-term review. Unfortunately, I was not able to check that date with the ESRI. The author changed the text to meet the Department of Finance's suggestions, or made some changes, and when I came back I discovered this had happened. We had put the thing to bed. However, what John McManus in his story did not realise was the role *The Irish Times* played in this. A few days after we published on 15 October, all of the things that had been taken out were published in an article in *The Irish Times*. It was a very perceptive article on the serious mistakes that were possibly being made in separating the Financial Services Authority. The material found its way into the public domain and it should not have been taken out.

My memory of the discussion with the director and of the director's view was that the author had just left the institute. I was not in a position to talk to him when I came back from Warsaw and I had other things on my mind. That would be most unusual. On that medium-term review, we received a letter after publication from a senior official in a different public institution saying the ESRI had committed treason in it. I think the word used was "treason". That was because we had suggested that corporation tax should be raised from 12.5% to 15% or 17.5% between 2011 and 2015. The official asked that we withdraw the medium-term review. That is my memory. There was a much more normal Department of Finance reaction. The Department was copied on that correspondence and my memory is that the director told me it telephoned him to say, "Ignore that". It was not normal.

The Department of Finance comments appeared to me to be highly political and it would not be something normal. I outlined before how I would respond and it would be left to me to respond. It would not come from the director. It would be left to the authors. If the Department of Finance makes good points, I take them on board. It normally does. If it makes political points, I do not. It is the same with other bodies to whom we send the material as well.

Deputy Pearse Doherty: On the freedom of information response which was reported in *The Irish Times*, the official said that the author of the section apparently had some problems about the perceived interference with their independence. The unnamed official went on to say, "This is not something I find holds much water". The article also says that Professor John FitzGerald was the person who edited the report. Professor FitzGerald acknowledges that it should not have happened, but he was the person who did it.

Professor John FitzGerald: Yes. I was in Warsaw and my decision was that it should not be amended. When I came back, I found that it had been amended. The problem was that when John McManus talked to me about that, I did not know the details. It was only after he published the article that I talked to the author about what had happened.

Deputy Pearse Doherty: There was a draft mid-term review which was quite critical of what the Government was doing on the changes to the Central Bank and the regulator. Professor FitzGerald amended it to contain the more nuanced and suitable language the Department of Finance was looking for. Am I right to say that Professor FitzGerald acknowledges that was a political call by the Department of Finance but that he did it?

Professor John FitzGerald: I did not do it. My decision was that it should not happen. However, it had happened when I came back from Warsaw. The author had left the institute at that stage, I think. I had no conversation with him. I came back on 2 October and the first set of files was finalised on the first not the second of the subsequent set. It was a lapse, but my decision was that this was political and it should not happen.

Deputy Pearse Doherty: Was this censorship by the Department of Finance?

Professor John FitzGerald: No. It was a nervous Nellie in the Department of Finance. The Department of Finance is interesting. The fact that we were suggesting raising corporation tax was not a problem for the Department. The normal people who dealt with us in the Department would view that as the normal call of the ESRI. It was somebody in the Department of Finance in a different section who did not normally deal with us and it should have been ignored.

Deputy Pearse Doherty: Were changes requested and made to the medium-term review of 2008?

Professor John FitzGerald: The Department was grumpy in its comments on that. One can get its comments under freedom of information. It was not that helpful. The Department was upset with a report we did for it in 2006 on investment priorities which said its plans for investment were way too ambitious and it should take money out of the economy. The Department was cross that we published that. There is a reference in the comments to us revisiting that where it was said to us, "Get over it; you were wrong on that". I do not have the comments in front of me-----

Deputy Pearse Doherty: If the Professor does not have them, we will not dwell on them.

Professor John FitzGerald: -----but they were unhelpful and, therefore, largely ignored. If what the Deputy is getting at is the suggestion that the Department told us what to say regarding the economy, the answer is "No". He can get the comments and he will see there is nothing about that in them. It was our mistake. What I was interested in was whether the Department was saying that what we said was being too ambitious but it did not do so.

Deputy Pearse Doherty: In March 2001, Professor FitzGerald was critical of the then-Minister for Finance, Charlie McCreevy, and the changes made to the 60% capital gains rate on zoned lands. *The Irish Times* reported Professor FitzGerald saying there was no incentive for the developers not to hoard land that should be used for residential development. He was also critical of the Minister's plan not to proceed with the 9% stamp duty on second homes and the 2% anti-speculation tax for the first three years on those homes. Can the Professor explain to the committee what the issues were and why he felt he needed to criticise the Minister so publicly in relation to this? What was the effect of those measures on zoned land and of the dropping of what was labelled at the time the "anti-speculator" tax on second homes? What type of engagement was there between the Professor and officials and the Minister in response to those criticisms?

Professor John FitzGerald: I cannot remember. I am delighted I was as critical as I was. The ESRI tends not to campaign. Instead of saying a Minister is mad, I would say, "The policy is unwise". I am surprised I was upfront in any criticism there. In terms of interaction with the Department of Finance, there would have been much closer discussions. There was a cultural change in the Department of Finance in the last decade. It became more concerned about the politics of things and less interested in the technical detail. I would have had less interaction. Also, I was getting older and having been in the Department of Finance up to 1984, I would have had lots of friends. On that, we published an article in 2001. I went back last night and looked at the 1999 medium-term review because of the issues I heard the committee was going to raise. Even then, we were critical of fiscal policy, which is what the Deputy is talking about. The fiscal policy was most unwise and it fuelled the problem. If we had a sensible fiscal policy, we would not be where we are now.

Deputy Pearse Doherty: In relation to the expertise the ESRI holds, notwithstanding that it got a number of things wrong as the Professor has acknowledged, were any officials, including the Professor, contacted by the Department or the Minister in relation to the events leading up to the guarantee, the decision itself or afterwards? Was there any consultation with the ESRI and were its views requested by anybody in that regard? If so, can Professor FitzGerald outline to the committee how that took place?

Professor John FitzGerald: There was no consultation whatsoever with us. Relations would have been frosty and the Department would not have wanted to come and talk to us about this. To my knowledge, there was no discussion prior to the guarantee. Subsequent to it, the Minister came to meet people in the institute. I have here the dates, which were 14 January and 20 March 2009. I may then have met the Minister on 5 October. I met him with David Duffy on 11 February 2010. Finally, I was at a meeting with the Taoiseach, the Governor of the Central Bank and Minister for Finance, at which many officials were present, on 16 October 2010. In the meetings with the Minister in 2009 we concentrated on issues other than the financial sector because we had not done research on that area. One area that did feature was our research on the public sector pay premium which the Minister discussed with my colleagues who were experts in that area. There was a range of issues in that the discussion was in our area of expertise, fiscal policy, how we were to get out of the mess. I specifically remember that when he raised the issue – and he was interested in our advice on the financial sector – we said he should talk to Patrick Honohan in Trinity College, he was the expert on that. That happened either at the meeting on 14 January or on 20 March 2009.

Chairman: I would like some clarification on the professor's response to Deputy Doherty. He said he wrote to the Central Bank in 2006 expressing a series of concerns. Is that right?

Professor John FitzGerald: Yes, it was addressed to the regulator.

Chairman: What were those concerns?

Professor John FitzGerald: We led a network of ten European research institutes, which did independent forecasts for the EU Commission and in January 2006 we had a preliminary meeting to draw up the forecast in Warsaw. I became aware, partly through the assistance of the Irish ambassador there that there were many Irish investors who wanted to invest a lot of money in property in Poland. My concern was that they would have leveraged, borrowed, large sums from Irish banks, gone to Poland, and, using that as equity, leveraged again. My concern in particular was that one Irish bank had a major bank in Poland and that Ireland could be exposed unduly through this form of investment so I wrote to the regulator about that.

My concern in March–April 2007 was that I had done work with banks providing them with macro-economic scenarios, stress scenarios, where things go really wrong - it is ironic that we did not heed our own advice on this – in the period 2005 to early 2007. We gave them macro-economic numbers. What they did with them after that was their own business. I was concerned that the stress tests undertaken by the Central Bank were not onerous enough. They examined a fall in house prices but did not take account of the fact that a lot of other things would happen at the same time. They were not using a model to do this. I contacted the Central Bank about my concerns in that regard in 2007.

Chairman: Did you get a satisfactory reply from the regulator to both sets of correspondence?

Professor John FitzGerald: No.

Senator Michael D'Arcy: Professor FitzGerald is very welcome. In respect of no censorship, no influence, when people make statements and use words like "treason" about documents the professor publishes is there not a certain amount of latent influence-----

Chairman: That is a leading question. The Senator may ask a question but cannot make the statement himself.

Senator Michael D'Arcy: Is there influence in the use of words such as "treason" about papers the Professor publishes? Is there a latent influence?

Professor John FitzGerald: I was furious. It may not actually have been treason. I heard only last night that this would be brought up and I have not had access to the letters involved. There have been occasions when people have contacted us and I have been very annoyed and I would certainly do the opposite. Nobody tells me what I am to do in my report. It is my responsibility. The director does not say, "You can't say that". It is for me to decide. I was furious and the director was furious. We had not come across this before. My memory is that the director said that he was telephoned by a senior official from the Department of Finance to say this was over the top and to ignore it. If people come in with their studs up it does not make one happy. It makes one more inclined to do the opposite. Points are much more likely to score and nudge one when people make reasonable arguments and one says on balance maybe they have a point. When people do that kind of thing it does not go down well, especially when one is independent and free to choose.

Senator Michael D'Arcy: Could it influence a less senior member of staff to temper his or her language or their paper?

Professor John FitzGerald: I have had occasion with joint authors when a junior member of staff has come to me saying the comments he or she has received from outside were way over the top. I have agreed and said they should be ignored. I managed a division of the institute for several years and my view was if they were good comments take them on board, if not, I said, "It is your report, you are the author, you are responsible for what it says and don't be pushed around."

Senator Michael D'Arcy: The professor makes the point that he decides what he does within the ESRI in respect of the papers he publishes. The ESRI is probably the largest economic think tank in the State. I looked for the analysis of the nation's banking sector collapse. There seems to be very little analysis by the largest economic think tank of the €100 billion collapse of the Irish banking sector. Why is there little analysis of that nature when one considers the size of the collapse in the Irish economy?

Professor John FitzGerald: If the Senator looks at our update of the medium term review in 2010 and the medium term review 2013 - this is what I was specifically responsible for – we tried to take account of what had happened in the financial sector and consider what policy measures should be put in place and where Ireland is going. Research takes time. The ESRI does quality research. That cannot be done in three months. It takes probably a year to do a research project. The Senator could look at the research coming from my former colleagues now on matters such as credit for SMEs and a whole range of papers on micro-economic data. The Central Bank has also done excellent research so that our understanding of the problems posed for this economy by the banking crisis and the failure to resolve it quickly is much better.

We will not re-do what the Central Bank is doing. My colleague, David Duffy, has done papers on negative equity. A great deal of research is coming out now. The ESRI woke up and said it had to look at this but it did not want to duplicate what the Central Bank is doing because it is doing very good research now. We have done a great deal of research on this and try to bring it together in the medium review.

In that review one of the scenarios we examined was where the rest of the world did okay and we did not exploit the opportunities. I have forgotten what we called the scenario, the wasted opportunity or something because the banking system was not put right, it looked to us that the problem in the banking system could damage the economy but that was at a macro level. At the same time many of my colleagues are doing research at a micro level and saying it could be a real problem for SMEs although the research suggests that until recently SMEs and credit were not constraining the Irish economy. The problem was that people did not want to invest but our concern in the 2013 medium term review was that the recovery might not be as strong as it could be or might be delayed because the financial system was not available to finance the economy. Post 2008 the Senator will see a lot of research done by the institute, which is relevant and encapsulated in a range of publications.

Senator Michael D'Arcy: I thought there would be a macro level paper encompassing how the collapse was as extreme as it was. What the Professor is saying is that there were several-----

Chairman: That is a leading question. The Senator may ask a question but if he is asking the witness to verify his own commentary that is not a question.

Senator Michael D'Arcy: Why is there no macro level paper on the banking collapse?

Professor John FitzGerald: The 2013 medium term review looked forward rather than back.

Senator Michael D'Arcy: Before Professor FitzGerald comes in with that, it is five years from the night of the bank guarantee. Why did the ESRI not conduct a full analysis of the banking sector looking back, using a particular date?

Professor John FitzGerald: There was an interesting article in *The Irish Times* last week by the Governor of the Central Bank with a colleague in the Central Bank, Thomas Confrey, a paper which the Governor gave at the conference of my retirement. He has done a preliminary job on that. It would be interesting, using the models because the models are valid if certain adjustments are made to them, to do a counter factual, to go back. I have retired. If somebody wanted to ask me to do it I might do it. There is a lot of work to be done where one has to go back and replay, using appropriate models, the last decade and say, if one had run appropriate fiscal policy how high would interest rates, tax rates and the surplus have been. It would be instructive and would be valuable to do. Over the rest of this decade and it is an issue for the next Government, it may be necessary to move to a large surplus if the recovery is vibrant to stop the economy overheating towards the end of the decade. We need to understand that. That is a very interesting research project and will require significant resources to look and see what might have been.

Senator Michael D'Arcy: Does Professor FitzGerald think it should be done?

Professor John Fitzgerald: Yes, it should be done.

Senator Michael D'Arcy: Again, what I am asking is why the ESRI has not done it?

Professor John Fitzgerald: The resources to conduct a medium term review are probably €0.25 million and a number of staff would be needed for a year to work on something. It would be less for that because a new model is being developed, Cosmo, which has the best of HERMES - all these acronyms - in the Department of Finance with the co-operation of the Central Bank. I think they are working on a financial sector for that model which would make it particularly suitable. It is a major research project over a number of years and one is talking in terms of major resources. When that model is ready, which I think will be this year, I am not sure whether the financial sector would be integrated into it but that is the tool one would want to use. I would wait until an appropriate tool is ready, but research takes time if it is to be done properly.

Senator Michael D'Arcy: Last week Professor William Black was quoted as saying that the bank guarantee was an insane decision. He also said it was the worst possible decision. What is Professor FitzGerald's opinion on the bank guarantee?

Professor John Fitzgerald: The now Governor of the Central Bank gave his inaugural lecture in Trinity College in, I think, December 2007, and identified five possible responses - the best, second best, third best. At the time he said the Government chose the fourth best. It had to do something. We now know that it was the wrong decision but I did not know that the Senator wanted to take me down the bank guarantee area. It is not something on which I have done specific research. I was not consulted on it.

Senator Michael D'Arcy: May I ask for Professor FitzGerald's opinion on the establishment of NAMA?

Professor John Fitzgerald: I think it has done a pretty good job. It looks as if the State, instead of losing money, is going to get something back. There was much concern when it was set up - this is taking me a bit beyond what I expected - that it would be used to recapitalise the banks, to make life easy for the banks. We now know that, if anything, it was a bit tough on the banks. The discounts that applied to the assets were appropriate or maybe even bigger than necessary. I think it has helped in terms of the recovery and sorting out the problem. The concerns which were expressed when it was set up have turned out to be totally wrong. Partly because of that, because NAMA wanted to do a good job, the criticism was that it would be kind to the banks, it made sure it was not kind to the banks.

It is not my area of expertise.

Senator Michael D'Arcy: May I ask Professor FitzGerald's opinion on the national bailout?

Professor John Fitzgerald: I have published on this. If the Chairman wishes, I will go down that route.

Chairman: I am aware that the committee at the context phase of the inquiry wrote out and gave a broad scope as to the area we may be going into. I know this is an issue that was not flagged with Professor Fitzgerald for this morning and that the Senator is going into areas that were not part of his preparation. If he wishes to respond I will give him space to do so.

Professor John Fitzgerald: I will do so briefly. In a paper on budget perspectives 2012 or 2013 - I have updated it since - I looked at the approach taken in Ireland and the approach taken in Spain. I think we got it broadly right. Basically, we under-promised and over-delivered whereas in the Spanish case it over promised and under delivered. We have done roughly the same and got to roughly the same position. What makes Ireland different is that the outgoing Government decided to take a pessimistic view of the public finances, three months before the election in its paper of October-November 2010, and set targets which have been difficult to reach but were politically possible so that the incoming Government was handed a plan that was deliverable within target every period. By contrast, in the Spanish case what happened was that the outgoing government continually raised the bar and promised it would get the deficit down to 3% even faster, something the incoming government finds it is impossible to achieve. People say Ireland meets its targets and Spain does not. It mirrors what happened in 1986, 1987 and 1988 where the political system across party boundaries delivered a resolution which produced a better adjustment for Ireland. The bailout in terms of the plan was an Irish plan developed by an Irish Government. The troika bought into it and said it was okay. The incoming Government said it did not like features of it and the troika agreed that so long it stuck to the broad parameters it could change it. That is what has happened.

I can go a lot further down this route but it would take the committee a long way from where it wants to be.

Senator Michael D'Arcy: In the spring 2010 quarterly economic commentary review, reference was made to the estimated cost of the recapitalisation of the banks at a figure of €33 billion. The comment in regard to the amount of €33 billion was that "This large addition to the national debt is manageable and in no way threatens the solvency of the State." What is Professor FitzGerald's opinion on that statement with the benefit of five years' hindsight?

Professor John Fitzgerald: Six months later we knew. In 2010, NAMA took the first tranche of loans from the banks at a discount and that suggested the hole in the banking system was €33 billion. We relied on the Central Bank's judgment in this regard. However, over the summer and into the autumn it became clear that the hole in the banks was going to be much bigger and we ended up putting €64 billion into the banks. We relied on Central Bank numbers. If we had known it was €60 billion we would have been talking about bailout, but we did not. That was an issue on which we would have needed inside knowledge to know how big was the hole. We knew - we would have talked about that in the summer 2010 update of the medium term review - that it would have been conditional and we would have recognised that we did not know the answer on that. The State had funding which would have seen it through to a number of years if it had been only €33 billion but when it became clear that the amount was €64 billion then a bailout became essential.

In terms of the debt, as it has turned out, because the interest rate is so low, the burden of the debt is substantially lower than we anticipated at the time. The debt interest is much lower than we had anticipated because an exceptionally favourable deal was done on the promissory notes where, basically, we are paying no interest on the €25 billion. In regard to the debt interest payments, it is what one pays on the debt that is important where the interest rate is low.

Senator Michael D'Arcy: In the programme "Future Shock: Property Crash" shown on RTE in April 2007, Professor FitzGerald made some very strong remarks. I am trying to understand how Professor FitzGerald's very strong views at that stage changed by the end of the 2008 medium-term review.

Professor John FitzGerald: That programme almost got me divorced. I said that if I believed what I said, I would sell my house and rent it back. I went back and Eithne said to me, "It's our house and we're not selling." I was in deep trouble and have been very careful ever since that it is our house. We did not sell. When I heard that the Senator was interested in that programme, I looked at it again. It was a very good programme that set out the risks. If one looks at the quarterly economic commentary published at the same time, it said that there was a serious risk of housing crash and a risk to the financial system. Up to 2008, we got it right. You are in the eye of the storm and on the edge of a precipice. There are two outcomes - one, you fall over the precipice and the other, you pull back. We picked the wrong one. It goes back to the questions that were asked earlier. If the rest of the world had not collapsed, we would have come through. In the eye of the storm, you do not see what is going to happen in the future. That programme was good. It reflected the thinking and publications of the ESRI and the concerns we had in that regard.

Senator Michael D'Arcy: Professor FitzGerald says that the ESRI does not campaign. Should it do so?

Professor John FitzGerald: No, you lose credibility. We are researchers, not policy makers. In respect of my own publications, I have concerns about endlessly repeating the same mantra in a number of areas. For almost 25 years, I have been saying that I am really concerned about global warming, that we should do something and that a carbon tax is the answer. I feel people say, "That's FitzGerald rabbitting on again". I felt the same with regard to my concerns about the housing problem. We felt isolated and felt that until "Future Shock", people did not take this seriously. I am not a politician, I have chosen to be a researcher. If you start campaigning and join the process, one side or other of the political process will say, "You would say that anyway". You would be devalued. It is important for me over my career to have established myself as independent of politics and not to campaign for or favour a particular side. It has been complicated over the years, with a wife and a father in politics. There have been headlines in newspapers saying, "FitzGerald criticised father" or "FitzGerald at war with wife". It has been particularly important for me but in respect of the institute generally, if you become a player, you are campaigning and your research will be devalued. Most of my colleagues and I examine our consciences if there is a headline that is about us rather than our research.

Deputy Kieran O'Donnell: I welcome Professor FitzGerald. He said the cost of producing the medium-term review is €250,000. Am I correct?

Professor John FitzGerald: Off the top of my head, you are looking at probably three senior staff developing and maintaining the model over the course of a year.

Deputy Kieran O'Donnell: Who would fund that?

Professor John FitzGerald: That comes out of the grant-in-aid from the Department of Public Expenditure and Reform which I think is €2.7 million. It is a large part of the budget so it is an expensive resource. One then has the quarterly economic commentary. In respect of macro-economics, we made the decision not to seek sponsorship because it would affect our independence.

Deputy Kieran O'Donnell: It is effectively funded by the Government.

Professor John FitzGerald: Yes.

Deputy Kieran O'Donnell: Taking up that theme, in his presentation, Professor FitzGerald spoke about a tumour. He used the analogy of a tumour in respect of how the property market and the banking sector had spread throughout the economy. How did such a tumour go undetected by the ESRI on the basis that it produced reports for the Department of Finance in 2003 on the national development plan, where it was very critical of the growth in the property sector, and a follow-up report in 2006, where it said exactly the same thing? Professor FitzGerald took part in the Kenmare conference in October 2004 and followed it up with “Future Shock” on RTE in April 2007. He used the same term on both occasions. He said that the economy was out on a limb due to the property market. With the benefit of hindsight, why did the tumour of the property bubble and the banking stream of funding go undetected by the ESRI? Why was it not highlighted in the 2008 medium-term review report, considering that up to April 2008 taxes were behind by €700 million, and €1.2 billion by May 2008, we were running a deficit of €3.6 billion and taxes in all areas were behind? Why did this tumour go undetected by the ESRI in such a hugely significant report as the medium-term outlook report in 2008?

Professor John FitzGerald: In my appendix, I go through how the problem and dangers to the economy from the housing bubble were identified going back to 1999 and in particular, the 2005 medium-term review. The editorial in the *Irish Independent* the next morning talked about the ESRI being the Grinch that stole Christmas because we were promising a property market collapse just before Christmas. We could not have been more explicit about the dangers.

Deputy Kieran O’Donnell: Yet you-----

Chairman: Deputy O’Donnell took about two and a half minutes to ask a question. I will give Professor FitzGerald an equal amount of time to respond.

Professor John FitzGerald: My concern was that I felt that by the end, we were campaigning on this issue and were in danger of losing credibility. There was a very good article by Professor Morgan Kelly published in *The Irish Times* between 25 and 31 December 2006 on the housing market dangers. I contacted him, told him that I felt we were considered to be cranks on the issue and that it was great to have another academic coming out and saying there was a danger and asked whether he would submit an article to the quarterly economic commentary, which he did. It was refereed and published in June 2007. I felt we were isolated and that people were not listening. People just did not want to know. There was an interesting interchange between my father, Garret FitzGerald, and Richard Bruton on the election results programme after the 2007 election. If my memory serves me right, my father, who was very concerned about the state of the economy and competitiveness, asked Richard Bruton why Fine Gael did not campaign on the dangers to the economy and the reply was that Fine Gael had used focus groups and people did not want to know. My father wrote an article in June 2007 on that issue.

Deputy Kieran O’Donnell: The ESRI is an independent body that does not occupy a political world. Why with all these winds in the air in terms of inflows of funds from US banks for the Irish banking sector and the property bubble that were highlighted independently on a myriad of occasions, did the ESRI baulk in the 2008 report-----

Chairman: I will give the Deputy back time but he cannot use language like that. He will have to withdraw that comment and rephrase the question.

Deputy Kieran O’Donnell: I withdraw the comment. Objectively, why does the 2008 report read as if things were normal and we were in for a soft landing? Why does one not get that sense of impending danger in terms of the property market and the fiscal situation for Ireland? If the ESRI is independent and was highlighting all these issues that came up in the media in terms of comments made by Professor FitzGerald’s late father, which were correct and very valid at the time, why when we read the report, does it not reflect that commentary?

Professor John FitzGerald: It is because I made a mistake. I thought at that stage that house prices had turned the corner, they were coming down gradually, and I thought the odds were we would have a soft landing. I was completely wrong. It was not because anybody told me. I actually went back and checked. Nobody was telling me what to do. It was my choice, and I made a mistake.

Deputy Kieran O'Donnell: Based on Professor FitzGerald's mistake, what was the fundamental issue in a situation where property prices were falling, there was the whole issue of the sub-prime market in the US and those funds were flowing into Irish banks as well? What was the basis for his decision, given he now honestly admits he made a mistake in the 2008 medium-term report?

Professor John FitzGerald: We relied on the forecast for the rest of the world by the IMF, the OECD, the EU, the ECB and the National Institute in London, and we were unwise to rely on them.

Deputy Kieran O'Donnell: Is it fair to say the HERMES modelling was outdated? Was there a problem with the ESRI's modelling techniques at that moment in time? Did it factor in the particular peculiarities of Ireland in terms of the banking sector and 25% of the economy being based around construction?

Professor John FitzGerald: Going back to what Senator D'Arcy said, if we had plugged in a world economic collapse, we would have had an economic collapse in Ireland. The problem was that nobody was forecasting that until later in the month. Then, six weeks later, we said there was going to be a recession in the course of the economic commentary. We put in inputs but, as I said earlier, it is a cop-out just to blame all the foreign institutions. We should have looked internally at the evidence.

Deputy Kieran O'Donnell: I will finish on one further point. Professor FitzGerald made reference in his statement to the fact 2003 was effectively where we took the wrong route. Looking back, he said that he highlighted to the Government over successive periods that particular measures should be brought in to control the housing sector. In 1998, and I remember the time, mortgage interest relief for rental investment properties was disallowed and, basically, was removed. Then, in 2002, it was restored. Why was mortgage interest relief restored for investment properties from 1 January 2002 onwards, when it had been removed for the previous four years? Did Professor FitzGerald highlight that to the Government in reports? On the face of it, this links into 2003 and it was a pivotal fiscal policy decision by the Government. Professor FitzGerald claims that the decisions could have been made by-----

Chairman: A question please, Deputy.

Deputy Kieran O'Donnell: Did Professor FitzGerald highlight that 2002 change?

Professor John FitzGerald: We highlighted the fact the Government was most unwisely stimulating the economy through that and a range of measures. We recommended getting rid of mortgage interest relief and taxing mortgage payments in 2001 and again in the 2003 medium-term review. If one looks at the media report in *The Irish Times* - I think it was after the 2005 medium-term review - they asked us what instruments we would use, and we said we would get rid of all tax reliefs and we would introduce a property tax, and there was a whole range of measures. This happened repeatedly. My fear was that I was seen to be campaigning on this issue.

The ESRI, not just me, has research going back to the 1990s on why property tax is a good idea. There was an article in 1984 on the effect of getting rid of rates on property prices. There is a huge amount of research-----

Deputy Kieran O'Donnell: Does Professor FitzGerald believe that?

Chairman: Deputy, I-----

Deputy Kieran O'Donnell: This is a final question.

Chairman: I am giving you a lot of latitude but you are way over time.

Deputy Kieran O'Donnell: That question was not answered.

Chairman: You took a lot of time talking without asking a question. I will facilitate one short question but I will not allow commentary.

Deputy Kieran O'Donnell: Does Professor FitzGerald believe the reintroduction of mortgage interest relief for investment properties was a key factor in fuelling the property bubble?

Professor John FitzGerald: It was mad, but it was-----

Chairman: That is a leading question. Just ask the question. Professor FitzGerald is here for one day. I manage the questions every day.

Deputy Kieran O'Donnell: Let me rephrase-----

Chairman: I ask you to ask the question. You know what a leading question is as it has just been described to you.

Deputy Kieran O'Donnell: Can I just rephrase that question?

Chairman: I ask you just to ask the question.

Deputy Kieran O'Donnell: Does Professor FitzGerald believe that the reintroduction of mortgage interest relief for investment properties was a factor in fuelling the property bubble from 2003 on?

Professor John FitzGerald: It was most unwise and it was one of a wide range of unwise decisions.

Chairman: Thank you. I call Deputy Joe Higgins.

Deputy Joe Higgins: The council of the Economic and Social Research Institute contains big business figures and senior Government figures. Is it an establishment body and does that influence the kind of trend of opinion that emerges?

Professor John FitzGerald: The staff of the institute would have very little interaction with the council. The council generally tries to have a trade unionist-employer representative balance as well as somebody from the voluntary sector. I am not sure who is a member now. David Begg was, as was Donal Nevin for a long period. I cannot remember, but Deputy Higgins has information on the membership. There is an internal process within the institute under the director but the council does not have any say and does not want a say in what the ESRI publishes because it would conflict. They are there to vindicate the independence of the institute, not to hamper it.

Deputy Joe Higgins: In Professor FitzGerald's mind, when he is publishing these various reports, he says he is not influenced by, say, pressure from various sources, such as the Department of Finance or whatever. Has he felt a pressure to play down bad forecasts because of the nature of the system, the volatility of the capitalist marketplace or, for example, a fear that a bad forecast might frighten the horses and cause shares to fall or something like that? Does that feature?

Professor John FitzGerald: No. Our job is to call it as we see it, without fear or favour. I suppose we all live in society and I suppose, subliminally, there may be an effect but, certainly, in terms of any overt pressure, because of our independence, the danger is we will over-react to it. Over the last decade, much of our time was spent saying, "You may think things are going well but actually there is a danger there". That was the continual refrain. It was not popular politically to say that but we said it. To give the political system its due, it continued to stump up the money for the ESRI's grant and did not try to use that to influence us. We have never felt pressure to modify what we say.

Deputy Joe Higgins: The introduction to the 2008 medium-term review, referring back to the same review of December 2005, stated, "While in that review we did not want to overdo the sense of foreboding, mindful of the fate of Cassandra, [we] still wanted to alert readers to our concerns", and it helpfully footnoted that Cassandra was a figure in Greek mythology. She displeased the Gods. Did the ESRI in any way feel like a Cassandra of the modern period and that, if it was too blunt as to the dangers in regard to what was happening then, like poor Cassandra, the political and economic Gods might seek to take revenge in some form?

Professor John FitzGerald: Unlike Cassandra, we would all be conscious of the fact that we are not infallible. In the 2005 medium-term review, if the Deputy had asked me at the time, and I think a journalist asked me, what probability I would have put on a housing price collapse, I would have said a third, but by late 2006 and early 2007, it was at least a half. However, in terms of pressure with regard to the 2005 medium-term review, my feeling is that it did not go down well politically. We did not have any interaction with politicians or the Department.

There is one instance where I do feel there was upset but it was probably at a high level in the Department of Finance and possibly not with the Minister. It was in our 2006 report for the Department of Finance where we said, "You have got to take money out of the building construction sector, it is dangerous". The high level in the Department of Finance was unhappy with our conclusion.

I presented the results at a seminar, on at least one or two occasions, with the then Minister, Deputy Cowen. He knew we disagreed but as a politician he knew people disagree all the time. I did not feel that he was upset but there was, I know, upset with our conclusion.

Deputy Joe Higgins: The professor said he does not like to campaign and was not comfortable moving from research. In the same introduction of 2008, he said:

> However, our essential message in this review is upbeat, recognising that there is a danger that Irish society could be transfixed by the current very real difficulties, missing the opportunity to plan and prepare for a better future in the next decade.

Does that paragraph not show he abandoned his role as an economic scientist for a motivational preacher?

Professor John FitzGerald: I think that was a bad paragraph. I am sorry about it. I regret it and I will regret it until the day I die. I feel that I did a reasonable job on many other things but on that I did a bad job.

Chairman: I wish to interject and shall give Deputy Higgins back some time.

The professor has acknowledged his regret on several occasions this morning. I advise members of the committee not to repeatedly ask the same question in order to get him to say it on the record. At this stage the professor has stated his regret between eight or ten times.

Professor John FitzGerald: It is like confession.

Deputy Joe Higgins: Is it possible that during the pre-crisis period that the professor and the ESRI reports were fixated on workers' wages and wage restraint? In the 2005 medium-term review wages were mentioned 86 times, mostly demanding wage restraint. At the same time, was he silent on the massive increase in profiteering within the housing industry and the huge burden that was placed on the same workers to try to buy a home and meet the mortgage payments?

Professor John FitzGerald: Our successive models on how the labour market operates is not that there are nasty trade unions looking for loads of money or that workers are looking for too much. It is that the labour market produces an outcome or it is an outcome of a market.

In terms of the growth in wage rates, this was not a moral statement that workers were getting too much or trade unions were looking for too much. I suggest the Deputy looks at our analysis. We said the economy was growing too rapidly and the housing market was growing and expanding. As I said earlier in my statement, in order to get the resources to build, and let us remember 14% of the economy was housing but it should have been between 5% and 6%, the Government had to bid resources away from elsewhere. How does one do so in the labour market? One raises wage rates. The outcome was a rise in wage rates which crowded out jobs. I mentioned we were destroying jobs - jobs in DELL and other jobs were going. The problem was not that people were looking for too much money. The problem was the building sector was too big and that put inflationary pressures on the economy, which was unwise.

Deputy Joe Higgins: There was speculation in building lands and developers and bankers made huge profits on the backs of young working people trying to buy a home. Did the professor ever come at the issue from that angle?

Professor John FitzGerald: In terms of tax measures, there was a decision to get rid of the higher capital gains tax on land in I think the 1997 budget. There was a whole range of things such as the inefficiencies and the problems in the building sector. The builders did well. Economic theory tells one that with a fixed factor the people who will make a load of money will be property developers and the owners of land. The failure to deal with this matter was a very bad mistake. We have had tribunals on this issue. It is where big money was made and the matter should be dealt with.

Deputy Joe Higgins: The professor referenced that the international crisis was a huge factor in the crisis that happened here and its extent. At the same time, he referenced Professor Morgan Kelly of UCD and articles he wrote in December 2006 and then in 2007. The articles he wrote predicted that a huge crisis would be due to what was going on in Ireland without the international crisis. I ask Professor FitzGerald to comment on Professor Kelly's article dated 28 December 2006 in which he said:

If, however, we look at what has happened to other small economies where sudden prosperity and easy credit drove house prices to absurd levels, we should be very worried indeed.

Then he mentioned the potential for house prices to fall by between 40% and 50% and a collapse of the housing building industry. He referenced Finland and continued:

With low interest rates, and loans available for the asking, house prices soared. Then, as the Soviet Union collapsed, unemployment rose and house prices started to fall, creating problems first for builders, then for homeowners, and finally for banks. But why can't we just have our soft landing, where prices stay fixed or rise slowly for a while? Definitely not: a soft landing is not so much unlikely as contradictory.

On construction, he continued:

In Ireland, if and when the fall occurs, it will be from about 18 per cent of all national income. We could see a collapse of Government revenue and unemployment back above 15 per cent.

He concluded:

Pilots define a soft landing as one that you can walk away from. Looking at the collapses in Finland and The Netherlands and the building bust in Arizona, Ireland could be heading for what they call CDIT: controlled descent into terrain. You are happily descending through cloud, thinking yourself at a safe altitude, until suddenly you smack into a hillside.

The article was published on 28 December 2006. Some of those views were repeated in the medium-review article of 2007. Should it have been clear to people like the professor and others, not to mention the Government and other pillars of the establishment, that a disaster was in train?

Chairman: We will wrap up after this section.

Professor John FitzGerald: That article was excellent. It was so good that I got on to Professor Morgan Kelly and asked him to say it again in an article for the quarterly economic commentary, and he did. I asked him to do so because his article was repeating what we had said in the medium-term review in December 2005 where we looked at a fall in house prices of one third which would give rise to unemployment rising above 11%. Since 2005 and up to the end of 2006, house prices continued to rise so I felt it was sensible. It was great the he was coming out and somebody else was making the running on this. I said to him that I would like him to submit an article. He did so and we published his article with which I totally agreed.

In the spring 2007 quarterly economic commentary, my colleagues talked about the risks to the financial sector, so we got it right. What is interesting, under FOI, and this may come up later - is it in Nyberg or under FOI - is the reaction of the Department of Finance; they saw it and they rewrote it for the Minister, saying the ESRI expected a soft landing where we said there could be a soft landing. There could have been but we were uncertain because one cannot know the future. The mistake was 2008 for six weeks.

Chairman: I thank Deputy Higgins and Professor FitzGerald. I propose we suspend the meeting and resume at 11.25 p.m. Is that agreed? Agreed.

Sitting suspended at 11.10 a.m. and resumed at 11.30 a.m.

Chairman: I propose that the committee resume in public session to recommence our engagement with Professor FitzGerald. Is that agreed? Agreed.

Deputy John Paul Phelan: I welcome Professor FitzGerald. I want to start by referring to a couple of previous answers he has given. He spoke earlier about how he noticed a cultural change in the Department of Finance in the last decade of his time in the ESRI, and that some of its observations had become more political. I am interested to know whether, after the economic collapse, he noticed a change in that attitude again, or whether it remained like that.

Professor John FitzGerald: There has been a change again. The Department of Finance is a completely different place. They have got a load of economists who are doing interesting work and they are publishing it. It is in the public domain in articles in *The Economic and Social Review*. I have worked with them on a number of things. It is fun, they are encouraged to think outside the box. It is a very different world. I enjoyed working in the Department in the 12 years I was there. There was a team of very good economists and we were encouraged to disagree and so I think we have seen a cultural change back to a Department of Finance which I think is doing a good job.

Deputy John Paul Phelan: Can I ask - the professor referenced this himself as did a few of the previous witnesses, particularly the authors of the reports - if you were surprised that so few qualified economists were working within the Department of Finance at the time of the collapse, and did that have any effects on judgments that were made, in his opinion?

Professor John FitzGerald: First, I said on Vincent Browne's programme----

Deputy John Paul Phelan: We have all said things on the Vincent Browne programme.

Professor John FitzGerald: In January or February 2009, I said that the problem in the Department of Finance was that it had a number of very bright economists, but too few people working on economics. It was brought to my attention that there were a very large number of people with economics qualifications in the Department of Finance at the time but that was not the problem. I have worked in the Department of Finance and it is one thing having a qualification and another being a practising economist. It is a culture where you talk together, you disagree, and that was the kind of culture I had grown up in. I learned much of my economics in the Department of Finance but the numbers working in the area were very small. I suppose it was symptomatic of the culture - one of the reasons I left the Department of Finance in 1984 was that I was told if I wanted to be promoted I had to stop being an economist and go and do something different. I wanted to be an economist, so I left.

The HERMES model of the Irish economy was developed as part of an EU contract originally in the late 1980s, which my colleague John Bradley won. The results were published in a book by North-Holland - one of the best academic publishers - edited by the European Commission in 1993. Two of the authors were Department of Finance officials so they participated in this area. They continued to use it, but then the Department cut back the resources in that area and by the end of the decade was relying totally on the ESRI to do that kind of work for it, so that the Department put a much lower priority on work on economics. Certainly in the last decade I felt there were some really good people but too few of them and I think it showed.

Deputy John Paul Phelan: Was that a conscious decision within management in the Department of Finance, in your view, or was it something that just evolved over time?

Professor John FitzGerald: I think it evolved and there may have been some consciousness in the early years of the last decade that there was a need to change, but it did not change. I have had interaction with the Department over my career and many people are doing very interesting work there now.

Deputy John Paul Phelan: The professor referenced a letter he wrote to the regulator in 2006 expressing some concerns. Did he have any written or verbal concerns that he raised with the Minister for Finance at that time?

Professor John FitzGerald: I had no contact with the Minister for Finance over much of my career.

Deputy John Paul Phelan: Was that a conscious decision or why did that happen?

Professor John FitzGerald: In the ESRI you do not deal with politicians, you deal with the Administration. Politicians do not particularly want to deal with us - we are not necessarily helpful to them. It is not a marriage made in heaven although it is not divorce either. After the publication of the investment priorities report, I did at least one meeting with the then Minister for Finance, former Deputy Brian Cowen, explaining our point of view and he explained his point of view. He was not somebody who was going to take offence or whatever. He was very good to deal with, but that would have been just at one meeting. Even as a civil servant - I was a junior civil servant - one almost never got to see the Minister. I am trying to think about whether I met the Minister for Finance. I did meet Brian Lenihan on a number of occasions and I have itemised when I did so, but I do not think I met a Minister for Finance as part of a specific meeting otherwise in the 30 years that I worked in the institute.

Deputy John Paul Phelan: If Professor FitzGerald was writing to the regulator about these concerns in 2006, was there not a case to be made at that stage that those concerns should have been highlighted to the Minister for Finance?

Professor John FitzGerald: I am not sure because I do not have the files as to whether I did cc Finance on it, but Finance was not the relevant party. One of the problems was that you appoint people to do a particular job and you assume they do the job well and try not to duplicate. The person to go to on this was the regulator, not the Department of Finance. I may have - I do not have my files on that.

Deputy John Paul Phelan: In another answer earlier, Professor FitzGerald was speaking about the funding of the ESRI in his time there. He said that 30% of the funding now comes directly from the Department of Public Expenditure and Reform, DPER. In the period leading up to the collapse, 2003-08, the ESRI produced a property index in conjunction with one of the banks, Permanent TSB. Can I ask the nature of that arrangement with Permanent TSB? The index ceased to exist until it was resurrected in 2013, I think, now in conjunction with Allied Irish Bank.

Professor John FitzGerald: It was a technical issue where we brought academic expertise into how one constructs an index, in the late 1990s as far as I can remember. They provided the data - it gave us access to data we would not have had access to and the *quid pro quo* was a joint product. A significant amount of research was done using those data.

Deputy John Paul Phelan: Was it funded by-----

Professor John FitzGerald: Oh yes, it was funded by PTSB.

Deputy John Paul Phelan: Was that not on the face of it at least a conflict-----

Professor John FitzGerald: We reflected. I would not have been the person making the decision on it - it would have been the director who decided - but we definitely did reflect on whether it was wise to associate the ESRI's name. There was a risk but we felt it gave us access to data and provided data to the wider public that was of value and that it overcame the risks. I am not sure whether one would do that again, but it certainly I think it did produce a lot of good results and produced information which would not otherwise have been available in terms of monitoring the housing market.

Deputy John Paul Phelan: Can I ask in terms of the ESRI's economic modelling, has it ever been benchmarked against international standards from other European countries or even further afield?

Professor John FitzGerald: On that, the model grew out of a long-term collaboration on developing tools between the ESRI, the Central Bank and the Department of Finance. I was in Finance, John Bradley was in the Central Bank - he moved to the ESRI. In the late 1980s, John won a contract from DG12 to develop a model of the Irish economy and it was to be models of each of the EU 12 economies done by contractors. That result was published in a peer-reviewed book published by North-Holland with the editor being the European Commission. It was published along with the models of other economies. There were various problems with the contract, partly because the person doing the German model did not deliver and one cannot have a model of Europe without Germany. We and the Federal Planning Bureau in Belgium have continued to develop and use the HERMES models. John Bradley, my colleagues and I published a series of articles in a range of peer reviewed journals, which published the background to it. The book was also peer reviewed. There are probably approximately 20 or more peer reviewed articles in academic journals on parts of the model or using the model. During the past four years there has been one on the effect of the corporation tax change in economic modelling, one in the *Journal of Environmental Planning and Management* on carbon taxes, two in the *National Institute Economic Review*, one of which examined fiscal policy over the past decade and the mistakes made. There are many. Finally, a peer review of the ESRI by academics from outside Ireland and some Irish experts is published on the website, and is very favourable in its assessment of the ESRI's macroeconomic work.

Deputy John Paul Phelan: In light of Professor FitzGerald's earlier answers that the model did not take into account financial services and the financial sector to the extent that it should have, has it been subsequently rectified? Until Professor FitzGerald left the ESRI, did the model reflect financial services?

Professor John FitzGerald: Do not blame the model, blame the users, namely, me. My former colleagues in the ESRI are developing a follow-on model which will include most of the key aspects of HERMES and the intention is to have a financial sector sub-model. Although we had a banking model in HERMES, after the data changed completely in 1999 we did not pay much attention to it. The users rather than the model were at fault. A model never produces the right answer. Giving a model to a person who does not understand it is like giving a box of matches to a child. It is dangerous. The model has taken account of X, Y and Z but produces a wrong answer because it has not taken account of the financial sector. A model is a tool. It does not produce an answer. The person using the tool produces the answer.

Deputy John Paul Phelan: Why did Professor FitzGerald and his colleagues not pay much attention to HERMES after the data changed in 1999?

Professor John FitzGerald: In modelling, one needs a continuous series of 15 years of data. Monetary union completely changed the data such that we needed another 15 years of data, which we now have.

Senator Susan O'Keeffe: Professor FitzGerald said he had not been consulted about the bank guarantee. Does he mean formally nor informally? Did nobody think he might have something useful to say?

Professor John FitzGerald: No. I think it was on my wedding anniversary and I remember talking to Eithne the night before and saying the Government would have to do something.

Senator Susan O'Keeffe: And did anybody consult Professor FitzGerald in the weeks leading up to it?

Professor John FitzGerald: No.

Senator Susan O'Keeffe: Nobody thought of it. Notwithstanding the Chairman's acknowledgement of Professor FitzGerald's taking responsibility for what happened, did he consider resigning?

Professor John FitzGerald: No.

Senator Susan O'Keeffe: Why?

Professor John FitzGerald: I felt I had done a reasonable job over the previous 30 years and would continue to be able to contribute. I considered the fact that nobody else had done a better job.

Senator Susan O'Keeffe: When Professor Honohan was here, I asked him why, despite the failings and lack of management and oversight at the Central Bank during the time, nobody had resigned or had been asked to resign from the Central Bank. In his reply, he said various things had changed, but that he had organised his organisation to be effective and functional and was not sure he should have expressed a view on whether people should have resigned. As a member of the Central Bank board, does Professor FitzGerald think people there might have resigned or been asked to resign, given that accountability is something we should value?

Professor John FitzGerald: Given that I was appointed in 2010, I was not there at the time. By the time I had been appointed, the Governor, deputy governors and the people on the next rung were all new, therefore the issue did not arise. To determine people's personal responsibility, one would have to examine individual circumstances, and I am in no position to say anything on it.

Senator Susan O'Keeffe: Despite the level of work Professor FitzGerald did, particularly in 2005, he said people were not listening and he was concerned about it. Why does he think people were not listening and the Government did not act, given the seriousness of what he was saying and his personal reputation as somebody who would have known what he was talking about?

Professor John FitzGerald: Because it would have been very unpopular.

Senator Susan O'Keeffe: Are we reduced to that?

Professor John FitzGerald: The Government should have acted. The Senator will see in the appendix the list of publications over a continuous period. There was personal frustration which I tried - I think successfully - to cover up. The reason I mentioned the interchange between my father, Garret FitzGerald, and Richard Bruton was that it illustrates the fact that the people of Ireland did not want a change. The information was out there. The ESRI's 2005 medium term review was reported in *The Irish Times* and *Irish Independent* the following day. People could not have missed what we were saying, yet they went ahead and bought houses and the Government went ahead as if there was no tomorrow. The Taoiseach expressed strong views about doubters at some stage in the period 2005 to 2007. I am not a politician. The members are the people who can answer this.

Senator Susan O'Keeffe: Earlier, Professor FitzGerald talked about when he was in Warsaw and said he had written to the Financial Regulator on foot of his concern about developers potentially leveraging funding from a bank in Poland as well as banks here. Did he do that personally or on behalf of the ESRI? What made him suddenly think to do it at that moment, given that it was the realm of developers and bank financing in which, he has acknowledged, the ESRI did not have expertise.

Professor John FitzGerald: While I did not publish research, I was very concerned as an economist. I sat through a series of papers in Warsaw which showed a dangerous situation developing in the Polish market. Through the Irish ambassador, I then met a number of people and heard Irish developers wanted to buy the Villanova suburb of Warsaw for billions of euro, and it scared the wits out of me. It was not something in which Irish banks should have been involved and that is why I was concerned and wrote to the Financial Regulator. I subsequently talked to somebody in AIB. My concern was AIB might be in a double exposure situation. Whether it was correct or not, somebody in AIB told me that one of the areas of concern was whether mortgages were denominated in Swiss francs or euro and that the bulk of mortgages in Poland were denominated in Swiss francs. There is a problem given the way the Swiss franc has gone. I had a number of concerns. In the report we did for the European Commission as EUROFRAME, we referenced this and in the report published in spring 2006, I did an appendix - it is on the website in the public domain - about the concerns about both the Irish and Spanish housing markets. When we presented the report, the European Commission did not quibble with me about the Irish situation but brought in a Spanish expert to say Spain was not as vulnerable as I suggested. It was part of a process whereby information came my way and I was concerned.

Senator Susan O'Keeffe: Professor FitzGerald told the Chairman the Financial Regulator's response was unsatisfactory. Did the Financial Regulator's office not reply?

Professor John FitzGerald: It was not actually the regulator. It was the ins and outs of the Central Bank before then. Somebody senior from the Central Bank replied to me, and their reply did not reassure me.

Senator Susan O'Keeffe: Did Professor FitzGerald pursue that?

Professor John FitzGerald: No, because I do not campaign.

Senator Susan O'Keeffe: Would Professor FitzGerald have, on any other occasion, been as concerned as he was on that occasion, when he actually put pen to paper, so to speak? Would he have done that before?

Professor John FitzGerald: Subsequently, I became concerned that the stress testing of the banks was inadequate by the Central Bank and by the Bank of England, because I was involved with or had knowledge of one bank which was regulated by the Bank of England.

Senator Susan O'Keeffe: How did Professor FitzGerald manifest his concern?

Professor John FitzGerald: I contacted the regulator early in 2007 and sought a meeting to discuss my concerns but, for various reasons, it did not happen.

Senator Susan O'Keeffe: Can Professor FitzGerald recall whether the various reasons included a reluctance on anyone's part, or simply a diary clash or-----

Professor John FitzGerald: No, it could have been a maternity issue, but I cannot remember. The people involved were not available.

Senator Susan O'Keeffe: Would Professor FitzGerald have ever taken those concerns to a wider place or to anybody else? Did he think: "If I cannot get into that office, shall I go somewhere else?"

Professor John FitzGerald: No, the people who deal with that were the Central Bank and the regulator, as far as I was concerned. There was not another home to take it to. If they were not going to deal with it, then I was not going to campaign on it. I had not done research on it. It is knowledge that had come to me where I felt a duty to bring it to the attention of the appropriate authorities, but if the appropriate authorities did not do anything, then so be it.

Senator Susan O'Keeffe: How would Professor FitzGerald describe his own level of frustration over years of deciding he was not campaigning, which I understand, in terms of giving information to people and watching those people not take it, for a variety of reasons?

Professor John FitzGerald: I think if you are doing research in a public policy area, probably 70% or 80% of what you do is not directly followed up. If you get worried about that, then you should not be doing public policy research. However, your impact is longer-term and, over time, it may build up, and people may take account of what you do. Working in the Department of Finance, you are part of a process and, even if you think the Government is mad, you may feel that, at the margin, you can see you have influenced things. When you are in an ivory tower like the ESRI, you publish the research and you never know whether anybody pays any attention to it. It is a different mindset where you publish the research and your concern is whether it is good quality research and whether you are right. Generally it is, and, occasionally, as I have mentioned, it is not. That is your concern. As a citizen, you would like to see public policy sensible in Ireland and the fact it is not followed is a frustration, as a citizen. As a researcher, you should not get too hung up about it or else you will want to become a player.

Senator Susan O'Keeffe: During Professor FitzGerald's tenure at the ESRI, was he aware of efforts made to reduce the dependence on contracts or contractual arrangements, or work being done for Government in order to try to rebalance, if one likes, its income streams?

Professor John FitzGerald: We rebalanced our income stream because they cut the direct funding. Direct funding is low in the ESRI - if you look at the best in Europe, the Central Planning Bureau is wholly funded - and there are advantages and disadvantages to the funding model. The advantage is that the policy output and policy relevance of what we have done has been doubled or trebled since we were totally funded. The productivity increase in the institute over the last 20 years is dramatic. We are funded to do research on energy and it is policy-relevant, whereas if you are an ivory tower with money to spend and you decide what you are going to do, some of the time you will indulge yourself and do things which might not be of great use to policy. So the funding model has an advantage, but the disadvantage is there are areas that fall through the cracks that are not funded. The funding of macroeconomics would have been very limited and the funding of the financial research undertaken in the 1990s came from banks. They stopped funding it, however, and it would probably have been a major problem if the funding was still coming from banks in the last decade. They would not have continued to fund because you would have been saying there is a real problem and the banks would have been upset.

I think the model is too much in contract and in block grant whereas the untied funding should be substantially larger. Looking at other institutes across Europe, a 50:50 model would be a better model. It would combine incentives to be policy-relevant with the independence to pick areas that nobody else is interested in. For example, the ESRI was a leading area of research on poverty over the last 20 years but there has been very limited research funding for poverty, so staff have got to move on to other areas, and there are areas like demography that nobody wants to fund but which I think are important. There are cuts. When you are recommending cuts to the rest of the country, you cannot turn up and say: "We are special".

Senator Sean D. Barrett: I welcome Professor FitzGerald. There is a quote that reflects a lot of what we have been talking about this morning from the IMF multi-country report published just last month on the housing recoveries in Denmark, Ireland, the Netherlands and Spain. It states:

> Asset prices and other financial variables can help improve estimates of potential GDP. Most methodologies for estimating potential GDP do not incorporate information about unsustainable credit developments, housing bubbles, interest-rate movements, and other financial developments that can result in longer-term deviations of GDP from its potential trend. One way to improve estimates of potential GDP is thus to broaden the set of variables that a multivariate filter takes into account to add such additional information.

Does that not summarise a gap that we are now trying to address and, indeed, the crisis the committee was set up to investigate?

Professor John FitzGerald: There has been research which shows, in the simplistic models of estimating potential output with filters, that you will get a better answer if you include financial variables. There is a body of research on this. It was what you would expect but the problem is that the methodology is inappropriate. It is just taking the current EU methodology for establishing structural deficit and potential output, which is wrong and inappropriate for Ireland and gives the wrong answer. Adding in the financial variables, you may get a better fit but it is not going to come up with the right answer so I think there is a problem with this simplistic approach to estimating potential output. I can go down this route. I published an article in April of last year on this with my colleague, Edel Bergin, but it is taking us rather far from what Senator Barrett is talking about here. It is a very technical issue as to the filters and how you do this. I am happy to go down this route but it may take the Senator rather far from his remit.

Senator Sean D. Barrett: The contrast is with not taking into account credit developments, housing bubbles, interest-rate movements and financial developments. Professor FitzGerald said the single currency and monetary union required governments to behave differently. Can he expand on that?

Professor John FitzGerald: The Senator asked me a technical question and now he is putting a very different question, which is whether you should take account of what is happening in the financial sector. Of course you should, but when Senator Barrett talked about potential output, and when he is quoting from the IMF, that is a technical issue, which is different.

To understand how the economy operates, you should actually take account of what is happening in the financial sector. I mentioned earlier the papers by Kieran McQuinn and Gerard O'Reilly in the Central Bank, a number of which showed that credit was very important in terms of explaining what happened to the housing market. One of the problems, of course, is that that was a single equation, or small model, and credit is itself endogenous. You need to embed it in a larger model in order to understand the full role. That is one of the things the ESRI is working on in collaboration with the Central Bank in developing the CoSMo model to include the financial sector. However, just because a particular model does not have the financial sector does not, as I said earlier, excuse you from looking at that. It is a very important part of the economy. The HERMES model does not have the financial sector in it but we have used it to very good effect since the crisis to look at what is happening in the Irish economy because we bring our own human capital, our own understanding of the role of the financial sector, and add it on to the model. The question of formalising that in a formal model takes time.

Senator Sean D. Barrett: The monetary union required governments to act differently from 1999, as Professor FitzGerald said in the introduction. There is the old examiner's question: "Discuss...". What would "acting differently" have meant if we had the benefit of hindsight?

Professor John FitzGerald: You do not have the interest rate tool to manage an economy or to manage inflation and, in particular, asset market bubbles. You have to use other instruments, that is, fiscal policy.

Professor John FitzGerald: It was something which we did not anticipate or talk about. It is clear from the literature before monetary union, people were barking up the wrong tree about the problems of monetary union, not just in Ireland but elsewhere, that one needs to use fiscal policy to manage housing market bubbles. I published the paper in 2001 and the Treasury came over to discuss the issue with us because at the time there appeared to be an outside possibility that they might join. They published a paper in 2003 saying one may need to use fiscal policy to manage the housing market in particular. Yes, it is a new feature of monetary union. In terms of speaking with my German colleagues at a number of conferences in Germany people were jumping up and down saying their monetary policy was too lax and they could have a housing market bubble in Germany. My answer was that it need not have a bubble if it did the right thing on fiscal policy. I said they could control this in Germany and not to worry about the fact that there were low interest rates. I think we have learned. I am trying to pass on this understanding to my German colleagues and elsewhere that under monetary union there are different rules but one can manage an economy and one does not have to run into a crisis.

Senator Sean D. Barrett: There seems to be evidence from previous witnesses that in terms of joining the single currency in 1999 to 2006 those were crucial years and there was not a policy response such as that the Government should behave differently. What does Professor FitzGerald think happened in that period?

Professor John FitzGerald: I think there was a degree of hubris that pervaded Ireland. As a result of knowing the Senator would raise the issue of the 1999 medium term review, even going back to then and in each medium term review onwards, we raised this issue until it was too late in 2008 when the damage was done, that there was a need to use fiscal policy in a different way. In terms of the economics literature, the use of fiscal policy to manage the cycle had gone out of fashion, as the Senator is probably aware, saying fine tuning is not possible. This is not fine tuning, this is stopping disaster by using fiscal policy differently. Hopefully we have learned our lesson. It is something which need not have happened but did happen.

Senator Sean D. Barrett: A Nervous Nellie man in the Department of Finance.

Professor John FitzGerald: It could be a whole section; I do not know.

Senator Sean D. Barrett: Were views expressed to Professor FitzGerald in the controversy about the regulator for the financial sector, whether it would be in the Central Bank or entirely separate? Were telephone calls made on that issue?

Professor John FitzGerald: On which?

Senator Sean D. Barrett: On the McDowell report on how to regulate the financial sector inside the Central Bank.

Professor John FitzGerald: I was in Warsaw so I do not know whether it was in writing or on the telephone that the communication came to the director. The director discussed with me the concerns of the Department and it made it very clear that this was political. If they come up with arguments rounded in evidence one takes it seriously; there was no evidence, they just did not like it. I cannot tell the Senator because I only became aware of this last night and have not had an opportunity to trawl through. No doubt, under FOI, the committee can ask the Department of Finance if there were any communications and go after that.

Senator Sean D. Barrett: Did Professor FitzGerald have a policy on the best way to regulate banks that caused this telephone call or how did it arise?

Professor John Fitzgerald: When Patrick Honohan left in 1997 it left a gap in terms of doing research in the financial sector and we still had some funding and Mr. Colm Kearney joined us in 1998-99 but only stayed a year and is now in Trinity College. He may have moved to Trinity on the day before I came back from Warsaw; I am not sure, it was around that time. He was doing research in this area. I went back and looked at his article last night in *The Irish Times* which was really good. In regard to the serious mistakes being made, his argument was that the report done on separating the regulator used no evidence, did not look at what was going on outside and it was a bad idea. The Senator can read it in *The Irish Times* of 15 October 1999. It was a good article. He had done research in the area and had expertise. It should have been published but it was published a few days later in *The Irish Times*.

Senator Sean D. Barrett: For my last question, did Professor FitzGerald meet any contrarians in the banking system itself? Did any of the bank economists express concern to him? Did they see their own companies going over a cliff?

Professor John Fitzgerald: I was approached soon after the medium term review was published in December 2005 by people from AIB who said that the board was concerned that the stress tests prescribed were not stressful enough and asked if we would be prepared to do work. I said: "Look, at what we have done in the medium term review with a 30% housing price crash. You can pay us to do more if you want, but I think that is probably enough to give you." Also it was consistent with unemployment rising to 11% and so on. They said they would go off with it. What they did with it, I do not know but as far as I can remember, this initiative did not come from the AIB team, this was coming from somewhere higher in the bank.

Chairman: Before I move on to the next speaker may I put one question on that to Professor FitzGerald? In the stress testing proposal that AIB brought forward to him, was the issue of credit concentration limits actually part of that examination?

Professor John FitzGerald: In our role we did not want to get too involved with banks. We did macro-economic scenarios. The difference compared to what the Central Bank and so on was doing was that we used a model, so it was consistent. One did not get a housing price crash and no change in unemployment; one got a housing price crash, unemployment going through the roof and Government revenue collapsing, all coming together which is the way to do it. That was my concern. It was not just the Central Bank. It was interesting doing something similar with a British owned bank. The Bank of England and the Financial Services Authority, FSA, had a similar inappropriate approach to stress testing. I also learned from a third bank where we provide macro-economic scenarios because one of the scenarios it wanted to look at was a liquidity crisis. I should have paid more attention to what I learned from that bank because it was one of the factors that provoked the crisis.

Deputy Eoghan Murphy: I thank the Chairman and Professor FitzGerald. I want to look in the first instance at the relationship between the ESRI and the Department of Finance. I think Professor FitzGerald said earlier that in the interactions between the ESRI and the Department of Finance, he clipped them and they would grin and bear it but then in the last decade they became more grumpy. When he released the 2005 medium term review there was a different reaction, a tone change and a lot more media attention around it and much more coverage. Did Professor FitzGerald pay attention to that reaction to the medium term review in the press?

Professor John FitzGerald: We felt that we were fairly reported. One cannot say it was front page headlines in *The Irish Times* and the *Irish Independent*. As is its style, *The Irish Times* editorial did not have the sequentials to at Christmas. The reporting was out in the open. It was not that our reports were a secret. Over the decades in the institute we felt we had a duty to communicate our results to the wider public. We do not conduct reports for the Department of Finance, we do them for the people of Ireland. The press conferences are very important and the press has been extremely helpful. Some of them, great journalists such as Brendan Keenan and Paul Tansey, would always explain better what one was trying to say. The reporting was very good.

Deputy Eoghan Murphy: Was Professor FitzGerald then aware of any official reaction from Government?

Professor John FitzGerald: No.

Deputy Eoghan Murphy: Nothing comes back as feedback directly.

Professor John FitzGerald: We would have had technical comments. I could not find the file on what the Department said on that particular medium term review. I do not remember much kick back from it. In terms of doing a medium term review, we produce a draft set of numbers and send it to a large number of people, not just to the Department of Finance and the Central Bank but to other organisations to get feedback. We then get feedback and revise our numbers. When we talk to IDA Ireland and it says it has a real problem bringing in firms that should colour what we do. We would have discussed it in advance but I cannot remember a particular kick back from the Department of Finance on that one.

Deputy Eoghan Murphy: Was this the medium term review where there was an accusation of economic treason against-----

Professor John FitzGerald: No. That was 1999 and it did not come from the Department of Finance but from another public body and the Department of Finance was supportive.

Deputy Eoghan Murphy: From what public body did it come?

Professor John FitzGerald: I would have to check back. This came up last night. I am no longer in the institute and it is in the files of the institute. The word used may not have been "treason", I cannot be certain, but that was the import of my understanding. I am relying on memory, which I have had to dredge up overnight. If I had received notice this was going to happen, even a day earlier, I could have gone to the ESRI.

Deputy Eoghan Murphy: That is fair enough.

Professor John FitzGerald: This was in 1999, it came from outside, not from the Department of Finance, and the Department of Finance said, "You are independent. We disagree with you but you are perfectly right to do what you are doing".

Deputy Eoghan Murphy: Bringing us up to 2006, then, the Department of Finance commissioned the investment priorities report. In that, you were worried about the over-ambitious national development plan and a series of consequences for the economy. You already mentioned the over-inflated building sector. This was all reported in the media. You said, I think, that the Department of Finance was both upset and cross. You mentioned that you had spoken to the Minister but it was not coming from the Minister.

Professor John FitzGerald: I do not know. It was coming from the top. I do not have access to the Department of Finance files but the team working on this, the experience - I said I wanted somebody from the Department of Finance to ride shotgun with us, to go to all the meetings with everybody else because we learned a lot from it and I also felt they would too. The members of the team working on it worked very well and I think they were happy with the result although they may not necessarily have agreed with all of it. It was at a more senior level in the Department - my understanding was that they were unhappy.

There is other material on this. Harry McGee, in *The Irish Times* in October 2012, had two pieces where he got information under freedom of information. When we did the 2003 report and said that building construction was too hot and that money should be taken out of the sector, I got the impression that the Department of the Environment was unhappy with it, although I did not get that impression in 2006. What we now know as a result of the Harry McGee stories - or maybe Peter Nyberg, but I think it was Harry McGee - is that the Department of the Environment wrote to the Department of Finance in 2005 about its concern and the then Minister of State, Noel Ahern, the former Taoiseach's brother, got on to Finance to say his Department was concerned about the dangers. Within the Administration - I had heard this independently from the Department of the Environment - they were concerned about the issue. They did not disclose that in our meeting with them but they took action and said they also were worried.

Deputy Eoghan Murphy: How was this unhappiness with this in 2006 conveyed to the ESRI, this unhappiness at senior levels?

Professor John FitzGerald: It was not conveyed directly to me or the other main author, Edgar Morgenroth. My understanding is that there was a conversation with the director but this is hearsay - I do not know. What I do know is that in the comments to the medium-term review

2008, there was one reference which they still resented.

Deputy Eoghan Murphy: Coming up then into 2008, you spoke about the relationship with the Department being frosty prior to the guarantee. Did 2006 damage that relationship? Was there a chilling effect then, potentially, on the work of the ESRI?

Professor John FitzGerald: No, there are a lot of good people in Finance and they have different views and we would have worked closely with a team on the report. We had a very good relationship there. There would be nervous Nellies somewhere - I probably used an inappropriate phrase - and there are different people in the Department of Finance. What I do know is that it was at senior level, the concern about the 2006 report. Whether it was shared below or whether there were diverse opinions within the Department I do not know.

Deputy Eoghan Murphy: How was that relationship frosty in 2008?

Professor John FitzGerald: I got the impression that, whereas before, the role of the Department of Finance was such that policy proposals come from Government and the officials evaluate them and advise the Minister, say that they are unwise and so on. There was now a feeling at the top that you did not want to disagree or present difficulties, that the culture had changed. They seemed to be more concerned about the institute. They would always have said, for example, we were wrong on some aspect and they would express disagreement but one would know it was political. You know they are playing a game and you are playing a game, they have got to do it and you ignore it. However, they seemed to take it more personally, which surprised me. Where normally in my experience with Department of Finance officials the impression was it was accepted we had our job to do, that we were independent and could advise a course of action was unwise but that if the Government wanted to take such a course then the officials would have to act accordingly. Some of them seemed to buy in to what was happening in a way which was out of character with the past 30 years and out of character with what happens today. This is an impression based on limited interaction with the Department but much more research would need to be done on this before a judgement could be made on it.

Deputy Eoghan Murphy: So am I then right in thinking it was frosty on both sides? The ESRI had a particular view of the Department of Finance and the Department had a particular view of the ESRI.

Professor John FitzGerald: Yes, and we probably were not very - when we felt they were being inappropriate, they probably found us not very nice to deal with either because, as I indicated earlier, if somebody tries to beat us up we react by doing the opposite. Now one should be balanced on all occasions and there may be one or two occasions when our response to the Department might have been undiplomatic, I do not know, but-----

Deputy Eoghan Murphy: When it gets to 2008 and the medium-term review, is there a sense of either fatigue in the ESRI, given that previous medium-term reviews maybe had not been regarded as you hoped, or is there an attempt to rebuild a relationship there?

Professor John FitzGerald: There was no issue about rebuilding a relationship. The mistake in the 2008 one - we did not know where the economy was going and we made a serious mistake. There was more limited interaction with the Department and it came back with comments which were grumpy and - as I mentioned, that is probably an inappropriate phrase - but which were not that useful. They certainly were not telling us, “You are to say it is going to be a soft landing”. There was no suggestion, that was our mistake, unforced, my mistake, unforced.

Deputy Eoghan Murphy: Just to clarify that, you spoke earlier about this editorial conversation that would have taken place before publication, in which you did discuss perhaps mentioning the banks, but decided not to.

Professor John FitzGerald: I tried to talk to one of my colleagues last night on this and I may be wrong in the timing, but I think the way the quarterly economic commentary worked, there would be a review meeting where all staff would express comments and then there would be specific people who also read it independently. There may have been a discussion about the problems in Anglo Irish Bank but what I do know is that the 2008 summer quarterly called a recession and I think the Department was not that happy with the use of that phrase. However, we were probably much too mild in the use of it.

Chairman: Just to put a framework on what Deputy Murphy has been saying, in his earlier engagement with this inquiry, Rob Wright spoke about the information loop that should be in place between the Department of Finance, the Government of the day and maybe the Central Bank and other agencies. He said such a loop will provide a voice to take either pro-cyclical or counter-cyclical decisions on the economy in terms of over-heating or relaxing it and so forth. Given your engagement with Deputy Murphy, Professor FitzGerald, do you believe that information loop was effectively working during the period of, say, 1999 to 2006?

Professor John FitzGerald: My suspicion is that it was not. When I was in the Department of Finance in the period 1972- 84, one put one's views on paper and there would be a paper trail which would indicate if the boss was in agreement or not. What was more, in the 1977-79 period when we were very concerned about what was happening, not only did one go on paper but one took a photocopy of a file in case the file disappeared to make sure there was a paper trail. The Wright report says there were verbal warnings but could not find a paper trail of officials saying they had given a warning.

For me as a civil servant - it is the opposite of "Yes, Minister" - the job was to come up with the right answer, tell the Minister what the right answer was, and then the Minister would decide and one would implement the Minister's decision even if one disagreed with it. That is the way I was trained. However, it was on paper and a paper trail was kept so that one may be accountable, say, to this committee and one can show what was said. That does not appear, from the Wright report, to have been part of the culture of the Department. We also know from a number of freedom of information requests - I have details somewhere here, not by us but that appear in the paper, and also from the Nyberg commission - that the Department on a number of occasions amended what junior officials had summarised the ESRI as saying, to possibly say something that we had not said going up the line. That greatly concerned me. When I was in the Department one did not do something like that. There might be disagreement but it would have been on paper. That is my reading of Nyberg and what has come into the public domain.

Deputy Michael McGrath: Professor FitzGerald is very welcome and I thank him for the openness and candour of his testimony. I start with the approach by AIB on the issue of stress tests by the Central Bank. Was that the approach to Professor FitzGerald or the institute and when did it take place?

Professor John FitzGerald: It was to me and I think it was in early 2006. It would have been after the 2005 medium-term review because they were prepared to pay the institute to do work. I was uncomfortable and would have preferred not to have taken AIB's money when we had done what it needed already and it could pay €250 for the CD. I think it was early 2006.

Deputy Michael McGrath: Did AIB write to Professor FitzGerald or did someone approach him?

Professor John FitzGerald: No, I think I was rung up. I could check in my diary as to exactly when. It was someone I knew who said they wanted to come and talk to us. I think two people came from the bank and talked to me.

Deputy Michael McGrath: Did they explain the rationale behind their request for the ESRI to look at stress testing? It would have been something the ESRI had not done before and which was possibly duplicating what the Central Bank was doing. Did they express any concerns about the methodology of the Central Bank? Why were they coming to another institute?

Professor John FitzGerald: My understanding is that at a senior level in the bank it was felt that the stress test was not stressful enough. It is kind of ironic. They felt it was necessary to do a proper stressed economy. One needs a model to do that properly and AIB approached us to ask if we could do it. I said, "Actually we have done it already, here it is and you go off and use it". What happened thereafter is something the Deputy will have to ask AIB, but it was interesting. It was not just among economists in AIB that there was concern. It was at a more senior level.

Deputy Michael McGrath: At what level in the bank was the approach made? Can we ask who made the approach from AIB?

Professor John FitzGerald: It was a senior economist in AIB.

Deputy Michael McGrath: Professor FitzGerald then met two individuals.

Professor John FitzGerald: Yes, including the senior economist, I think it was two. The Deputy is asking me to rely on memory. What I know is that it was not just one.

Chairman: Going from memory, I would not ask Professor FitzGerald to use names, but he could identify the level from which those responsible were coming.

Professor John FitzGerald: It was a senior economist. I have pretty well identified him.

Deputy Michael McGrath: It is worth probing. This is a banking inquiry and the interaction of the ESRI with banks is a very valid line of questioning. Then, the Professor had a meeting with two individuals.

Professor John FitzGerald: Yes.

Deputy Michael McGrath: Did they express concerns about the approach the Central Bank was adopting in terms of stress testing?

Professor John FitzGerald: Yes. They said the people they were working for in AIB - it may have been in the board - were concerned that the stress tests were not stressful enough. My memory says it was the board, but it may not have been.

Deputy Michael McGrath: Was it Professor FitzGerald's sense that this approach had the imprimatur of a very senior level within AIB?

Professor John FitzGerald: This would not have happened unless there was very senior buy-in. They were prepared to spend money so this was something that was not going to go under the table. In the end, I said that we had done it already. While the ESRI always likes someone who is going to fund it, it gets kind of nervous.

Deputy Michael McGrath: Did it strike Professor FitzGerald as an unusual approach?

Professor John FitzGerald: Yes, and it first primed me to concerns in this area. I did similar work then for PTSB and - I might as well say it - Ulster.

Deputy Michael McGrath: What did the Professor do for them?

Professor John FitzGerald: It was macro-economic scenarios they were then going to use in stress testing. What interested me was-----

Deputy Michael McGrath: Did they pay for that?

Professor John FitzGerald: Yes. We updated the 2005 stress tests. What interested me was that the Bank of England-FSA approach was similar to the CBI-IFSRA approach.

Deputy Michael McGrath: It was about a year later that Professor FitzGerald approached the Central Bank in March or April 2007 to express concerns about the manner of the stress tests.

Professor John FitzGerald: Yes.

Deputy Michael McGrath: The Professor did that in writing.

Professor John FitzGerald: Yes, it was by email.

Deputy Michael McGrath: What concerns did the Professor raise in that correspondence?

Professor John FitzGerald: I said I wanted to talk to them about it, but while correspondence went on from April to June, the meeting never happened. I was busy doing other things as were they, so it never happened. Therefore, the communication of the details of my concerns did not happen. Possibly, I should have set them down in writing, but I thought it was easier to deal with them directly.

Deputy Michael McGrath: If the Professor was to characterise his concerns at that time, was it around the assumptions being used in the stress tests not being adverse enough?

Professor John FitzGerald: If one just asks what happens if house prices fall by 30%, one will get an effect. It becomes much worse if unemployment goes through the roof and Government revenue collapses with the Government then having to tax the hell out of the economy. That is a far worse scenario. What they were doing was just picking a housing crisis and unemployment independently, the reason being they did not have a model. To do the scenario properly in a way that is internally consistent, one needs a model of the economy. The only people with a model of the economy were in the ESRI.

Deputy Michael McGrath: The Governor of the Central Bank was sitting on the ESRI's council. Was the issue ever discussed at that level?

Professor John FitzGerald: The director of the institute deals with the council and researchers deal with the director. There would be no contact and no discussion between the Governor and individuals on their research. That would not have been a channel which was open or which one would have used.

Deputy Michael McGrath: Looking back at the period, is it Professor FitzGerald's view that the health of the banks and the banking system was the biggest risk to the economy at that stage?

Professor John FitzGerald: What I said in my opening statement was that we could have avoided this crisis with either appropriate fiscal policy or appropriate regulation and it would have been better to have used both. While we did not concentrate on the regulation, we got it sufficiently right on the fiscal policy.

Deputy Michael McGrath: In terms of the interaction with the Department of Finance and the political system generally, was there ever an example of what Professor FitzGerald would regard as inappropriate contact or inappropriate pressure by an elected representative, by a politician, on Professor FitzGerald personally or on the workings of the ESRI?

Professor John FitzGerald: I cannot remember such an occasion. The institute provides briefings for all political parties. That tends not to be for parties in government. Opposition parties tend to be more interested in getting our advice. We have done it for all parties. We have a duty to do that. We have interaction betimes with politicians but I cannot remember.

Deputy Michael McGrath: That is fine. Professor FitzGerald makes a strong criticism of fiscal policy and I want to tease out that with him. Looking back at the budgets for 2005 to 2006, inclusive, the forecast in terms of a general government balance was 0.8% for 2005, 0.6% for 2006 with the outturn for that year being better at a 2.9% surplus, and the projection for 2007 was a 1.2% surplus. What should the Government have been doing at the time? Professor FitzGerald referred to Finland and a 5% of GDP surplus. Is that the territory the Professor believes the Government should have been working within?

Professor John FitzGerald: Yes, it should have been ramped up with an ever-increasing surplus to take the steam out of the economy. It might have done better to have combined that with specific measures to take the heat out of building construction.

Deputy Michael McGrath: Professor FitzGerald related a very interesting anecdote about the 2007 general election. It is instructive for anyone to look at the manifestos of the time. Some might characterise it as a contest of who could give away the most. Why does Professor FitzGerald think there was such an approach by a number of political parties at the time? Was there something approaching a national consensus that low tax, high spend was the way to go and that the model was sustainable?

Chairman: That may be a bit leading.

Deputy Michael McGrath: I am sure Professor FitzGerald will not be led anywhere he does not want to go.

Chairman: I know.

Professor John FitzGerald: The Deputy is more expert than I am on that.

Deputy Michael McGrath: It was Professor FitzGerald's observation.

Professor John FitzGerald: Clearly, we had put out our warnings and the media had covered them very effectively, but nobody in the political system seemed to be that interested.

Deputy Michael McGrath: Is that nobody, whether in government or opposition?

Professor John FitzGerald: I have not gone back and looked at the Oireachtas debates. My impression was that people were not interested in taking the punch-bowl away.

Deputy Michael McGrath: One of the tools Professor FitzGerald recommended which could have been used to deal with his concerns on an impending housing bubble was to impose a tax on mortgage interest payments. When did he first propose that, how would it have worked and what reaction did he get?

Professor John FitzGerald: In a 2001 quarterly economic commentary article. It would have been that one would say to people, "Right, the interest rate on your mortgage is three percentage points. We are going to make a tax which is another percentage point on that." That is how it would work.

Deputy Michael McGrath: That would be paid to Revenue.

Professor John FitzGerald: It would be paid to Revenue and one could give the money back when the steam was taken out of the property market by getting rid of it. In terms of the reaction to it, people said, "You are quite mad. Politically this is impossible." It is one of the reasons that at a European level, central banks have been made independent. It is extremely difficult for governments to raise interest rates to do exactly this. That was one instrument. There are other instruments.

Deputy Michael McGrath: Was that model used elsewhere?

Professor John FitzGerald: Nobody has done it. It is important to have a debate on this issue now. We do not need an instrument now, but by the end of the decade we may need something. One could use property tax. The other instrument, which we continuously recommend, was that instead of increasing investment, the Government could have cut back its own investment. What we said was, "If you want to undertake this investment programme, you're going to have to tax the hell out of the building industry to make space, because you can't have any more building." There are a range of different instruments. Reading through the media reports on the 2005 medium term review, I think I was asked what instruments and I listed a range of possible instruments that would have had some effect.

Senator Marc MacSharry: I welcome Professor FitzGerald and thank him for taking the time. In his view, was monetary policy, as set by the ECB, in Ireland's interests in the period 2003-08?

Professor John FitzGerald: It was in Europe's interest. The point about joining a monetary union is that one sets monetary policy for the union. I mention in a footnote in my initial submission that Ireland suffered quite seriously from the effects of German unification in 1990. The economy was taking off in 1989 into the first quarter of 1990, then there was German unification. The German Government spent as if there was no tomorrow, telling the people of Germany that all the infrastructure investment would cost them nothing. German fiscal policy was thoroughly stimulatory. The Bundesbank then raised interest rates and the problem was that it was raising interest rates to deal with the German problem and the rest of us had to take its interest rates. The great thing about monetary union is that it is set for Europe, not for Germany, or not for Ireland.

Senator Marc MacSharry: Just to ask very specifically again - was the monetary policy being set in Ireland's interest?

Professor John FitzGerald: No.

Senator Marc MacSharry: In that context, is the EMU fit for purpose for a small open economy like Ireland? Will the interest rates ever be where we need them to be?

Professor John FitzGerald: Interest rates are there, going back to our experience in the 1970s, to manage the rate of inflation. The rate of inflation in Ireland is too low now, but the purpose is to manage the rate of inflation across Europe and anchor it. The ECB has done a good job in that regard. Other things one would use interest rates for, and make it appropriate for the Irish economy, are fiscal instruments. That is my point, that a monetary union-----

Senator Marc MacSharry: I get that point.

Professor John FitzGerald: Do not blame monetary union. One can have other instruments-----

Senator Marc MacSharry: I am not blaming the monetary union. I am asking a specific question. Will interest rates ever be where we optimally need them to be, because of the structure of the EMU?

Professor John FitzGerald: Sometimes they will. They will be optimal, because they are optimal for Europe.

Senator Marc MacSharry: They are optimal in a European context, but will they be optimal for us?

Professor John FitzGerald: What is vital to us is that the European economy works and subject to that, this will work. By accident, some of the time they will be right for Ireland and some of the time they will be right for Germany. That is why one must use other instruments.

Senator Marc MacSharry: Others have said in testimony here that the EMU was incomplete, that it was not fit for purpose in a crisis. Professor FitzGerald talked a lot about how fiscal tools could have been used. Given these constraints to do with monetary policy, would it be fair to say that fiscal tools need a longer lead-in period? For example, if one devalues a currency or puts up or down interest rates, that is pretty immediate, but for fiscal policy to have real effects in the day-to-day economy, we need a longer lead time. The policy would have to be set now to achieve an outcome in three, four, five or eight years time.

Professor John FitzGerald: No, fiscal policy is probably more immediate. The ECB has said that with its quantitative easing policy it hopes by the end of 2016 to get the inflation rate back to where it should be. It is about a two-year lead time, whereas fiscal policy would have a much more immediate impact. The problem with fiscal policy at the European level is that it is not co-ordinated. What should have happened was that, yes, we had to raise taxes and cut expenditure dramatically, as did Spain, but the rest of Europe - France, probably Italy, Germany, Netherlands - should have stimulated the economy. That is what should have happened. The problem is that all the fiscal rules that have been put in place are about making sure that debt is repaid. None of them is about co-ordinating fiscal policy. Also on rules, one of the reasons we got into a mess was that we had the Stability and Growth Pact. In dealing with the EU Commission and the IMF in the run-up to the crisis, in 2004-06, they would come and visit us and I would tell them they needed to give the Government a speeding ticket. Their answer was, “We can’t give them a speeding ticket because they’re obeying the Stability and Growth Pact.” Be careful of rules.

Senator Marc MacSharry: Professor FitzGerald said he received an unsatisfactory response from the regulator after raising concerns to do with property leveraging in a Polish context, specifically to do with an Irish bank having a large banking interest there and how people may purchase, use that leverage back here, and so on. Did that make him conclude in any way that the regulator was fit for purpose here?

Professor John FitzGerald: No, the regulator might well just give me a bland answer and do something. I was not party to the internal workings of the bank and, to tell the truth, I was not looking too closely at the regulation of the banks.

Senator Marc MacSharry: What did the regulator say at the time?

Professor John FitzGerald: I do not have it in front of me. It was something reasonably bland, as far as I can remember.

Senator Marc MacSharry: But Professor FitzGerald knows it was unsatisfactory.

Professor John FitzGerald: Yes.

Chairman: That is a leading question.

Senator Marc MacSharry: That is what he said, so I am asking him about it.

Chairman: Yes, but you do not-----

Senator Marc MacSharry: He said it was not satisfactory and there are other questions.

Chairman: When the meeting is over-----

Senator Marc MacSharry: I am just asking what made it unsatisfactory.

Chairman: I will give the Senator the time back later on, but if he wishes I will go over the replay-----

Professor John FitzGerald: -----a problem, we are dealing with it.

Chairman: I am stopping the clock now. I will go back over the text later on. These proceedings are recorded. Senator MacSharry asked a question but that was a leading question and we can watch the player later on if I need to demonstrate it to him. Professor FitzGerald is back in possession.

Senator Marc MacSharry: Just so I can put it on the record again, Professor FitzGerald said earlier on that he had got an unsatisfactory response, and I was just asking what constituted an unsatisfactory response.

Professor John FitzGerald: It seemed to me that they were brushing aside the concern. They may well have had good reason to brush aside the concern. I do not know.

Senator Marc MacSharry: Good reasons or not, Professor FitzGerald felt the regulator was brushing aside the legitimate concerns as raised by him.

Professor John FitzGerald: My suspicion is that the investment never took place in the Villanova suburb, so that my concerns may not have come to pass. For all I know, they might have known something, but I felt I had a duty to warn them and they came back and said, "Yeah, we've got your warning and we think things are ok". That was the end of it.

Senator Marc MacSharry: Professor FitzGerald said he made a mistake in 2008. The ESRI focused on the fiscal area as that was where the expertise was. He said had he looked at the data, he would have known. He also said it would have taken very little expertise to see the impending financial collapse. He mentioned that the Central Bank's economist looked at that data. Did they lack the little expertise Professor FitzGerald feels was required to see the impending collapse?

Professor John FitzGerald: I do not know enough about the internal workings of the bank, of who said what.

Senator Marc MacSharry: Was it Professor FitzGerald's understanding that their economist looked at the data, he just did not look-----

Professor John FitzGerald: I know they had many good economists. I should still have looked at the numbers. It would not have taken-----

Senator Marc MacSharry: Professor FitzGerald should have. He pointed out in testimony that it would have taken very little expertise to see the problem. To the best of his knowledge, the Central Bank had an economist who looked at this data, but for whatever reason-----

Professor John FitzGerald: The internal workings of the Central Bank and the role of economists in it at the time, and whether they were listened to, or what they were saying, I do not know. What we do know is that the regulator and the Central Bank were asleep on the job and did nothing.

Senator Marc MacSharry: They were asleep on the job. Professor FitzGerald mentioned a couple of times the exchange between his late father, Garret FitzGerald, and Richard Bruton on a post-election programme, what he had asked and so on, and Deputy McGrath mentioned some of this as well. To what extent did the discourse between political parties and manifestos fuel the problem? Before 2007 some parties were looking for increases of up to 57% in public expenditure, while many of them were talking about abolishing stamp duty, which could have been one of the fiscal tools referred to by Professor FitzGerald.

Professor John FitzGerald: I think that policy before and after the election was wrong.

Senator Marc MacSharry: The economic model has been criticised. How is a government or state supposed to foresee a crisis or even reach a proper understanding of its mechanisms afterwards if conventional economic theory does not acknowledge the role of banks or consider money and debt as influential variables?

Professor John FitzGerald: First, debt was very specifically included in the model. There was a very detailed section in the model as a result of what happened in the 1980s. Models are developed for particular purposes, but they are one of many tools. We used quite a number of different models in our research. The fact that the model did not have an operational banking sector did not mean that in using it one would not take that into account. We have used it very successfully since 2008. While we do not have a fully developed banking sector in the model - we bring a model in our heads or an informal model on paper - that is not the problem; the problem is with the users.

Senator Marc MacSharry: I thank the Chairman for giving me latitude. Does the fact that the ESRI is dependent on other sectors for 70% of its funding, rather than core Government funding, compromise its ability to give the attention and focus to the economic outlook that is necessary for a Government to take cognisance of it? Professor FitzGerald has mentioned how when he was in Warsaw, he focused on the implications of climate change regulations.

Professor John FitzGerald: You have limited resources and allocate them. Significant resources are allocated to the macro-economic area. We have additional resources in some areas. We do a lot of work on energy, communications and a range of other detailed matters. If there was more money available, there would obviously be more research, but that is a matter for the State. When we were arguing about cutbacks elsewhere, we were not saying, "You should massively expand research in that area." That is for others to decide. If the political system wants to recommend the undertaking of more research in that area, it would be very welcome, but to campaign on our own behalf would not have been wise in the past.

Deputy Pearse Doherty: Professor FitzGerald said that if the rest of the world had not collapsed, we would have come through. He also said that if the ESRI had foreseen the financial crisis, it would have been factored into its assessment of Ireland. Is he a subscriber to the view that were it not for the international crisis, the banks would have been sound? The reason I ask this question is that a number of witnesses who have come before the committee, including those who have authored reports on the banking crisis, say very clearly that it was a home-grown crisis and that the international financial crisis recognised the crisis here at an earlier stage. If the rest of the world had not collapsed, does Professor FitzGerald believe we would have come through?

Professor John FitzGerald: What I should have said was that we might have come through. At the time, if we had run it with a collapse in the rest of the world, we would certainly have seen it. I also said this was a cop-out because the numbers were available. We might have come through if the rest of the world had not collapsed; that is possible. Looking at the numbers now, we were in a really dangerous position, even without a collapse elsewhere and it is very possible that there could have been a collapse. The world economy had not collapsed on 17 March when Anglo Irish Bank was in difficulty and the ramification could have been that we had a really serious problem. The odds are that we would have had major difficulties even without an international collapse, but the international collapse triggered it. It happened much more rapidly.

Deputy Pearse Doherty: We know some of the figures for Anglo Irish Bank. What does a term such as "come through" mean? Let us focus on Anglo Irish Bank. In the absence of an international financial collapse does Professor FitzGerald think Anglo Irish Bank would still be trading? Does he believe its losses which we know are in the region of €34 billion would have crystallised, regardless of an international crisis? What does he mean by the term "come through"?

Professor John FitzGerald: On the basis of the information I have today, the odds were that there was going to be a financial collapse in Ireland no matter what. It might have happened a bit later, which could have been worse; it could have been an even bigger bubble. I cannot say for certain as I am not infallible, but the odds were very strong that there was going to be a big problem.

Deputy Pearse Doherty: Professor FitzGerald gave evidence to the committee that a senior economist in AIB had approached him in respect of a robust stress test at the bank in early 2006. I hope he will provide details of that individual for the committee at a later stage in order that it can follow through on that matter. He also said in his opening statement that the ESRI had not drawn a connection between the growth of the property market bubble and the risk to the financial system in 2008. Can he help me to understand how the ESRI did not draw the connection between a property market bubble and the risk to the financial system in 2008, yet in 2006 it was developing robust stress tests for the banks? How can both statements coexist?

Professor John FitzGerald: In 2007 we were warning about the risk to the financial system. I just go back and say I made a mistake. We were not ignorant of the fact that there was a major problem, but I just thought we might escape it. When Deputy Higgins read what I had said, the tone rather made me cringe - the tone of certainty that we would get out of it. We got it wrong, but there was a lot of information that there were problems and we were concerned about the issue. It is just that I plumped for and said we would get out of it without a crisis. Going back to Deputy Pearse Doherty's very useful clarification of what I had said, looking at it now, we were not going to escape unchallenged. I do not think I have fully answered his question.

Deputy Pearse Doherty: Perhaps it is still not very clear.

Professor John FitzGerald: The Deputy asked why I had not been concerned about the banking system, given that I had worked on stress tests and been concerned about them. I suppose it was partly because I had not taken it any further than macro-economics. I made it clear that I was not getting involved with the banks in their own internal workings; I was not a party to what they did after that. The fact that they were concerned did raise concerns for me, but in 2008 I thought we would escape the worst of it.

Deputy Pearse Doherty: Deputy John Paul Phelan spoke about the funding of ESRI research by Permanent TSB. Did Nationwide UK also fund ongoing research? Did the Irish Banking Federation, NAMA and AIB fund research? If that is the case, what proportion of research is funded by financial institutions? Does Professor FitzGerald believe there could be any suggestion of capture as a result?

Professor John FitzGerald: In respect of Nationwide UK, it was a survey of savings. There is a range of these surveys which are sponsored or where data are provided in the case of Permanent TSB, but that is not really research; it is data collection where we are happy to work with other bodies. The NAMA-Irish Banking Federation situation is different. There is a housing research programme and we are happy that a public body and the banks are involved as we feel they balance each other. There is a steering committee involving the Department of Finance, the Central Bank and the Department of the Environment, Community and Local Government. We feel that once there are enough different funders, as well as a broad public remit and an understanding that we can and will publish without censorship, this works well. We feel that the input, the suggestions that they have made, have been helpful. There is a working paper of mine now which is funded as part of that. We feel that it has worked well and if it does not work, then one gives up on it because the funders have got to understand that one is going to do one's own thing. In the energy area we would have a lot of different funders in there, which means that nobody can call the shots and it works well. One gets good suggestions talking to people in the outside world. Living in an ivory tower, it helps.

So if one gets it right, it can work. What the institute has done is maintain its independence throughout. One does not get into bed with one particular, especially private-sector body - one would be concerned about that - other than on data collection. We felt that influencing one on a formal statistical calculation of what the sum of the numbers are on house prices is not something which-----

Deputy Pearse Doherty: While I appreciate that, am I right in saying that the tenth anniversary Permanent TSB report did not just present figures? It actually referred to soft landing commentary, which Permanent TSB then relied on to state that it supported the ESRI's position. It is not a case simply of presenting figures or not - or is it the contrary?

Chairman: I ask Professor FitzGerald to respond briefly if he can.

Professor John FitzGerald: I would have to go back and look but what PTSB say is its business, what the ESRI says is its business. There would be the index and then they would publish their view of the index and if necessary we would publish a different view. We published our view on the dangers of the housing market, which were very different from what the banking sector was saying. So it did not compromise our independence, but I suspect what the Deputy is talking about is a report published by PTSB using the joint index, rather than a joint report. I could be wrong in that because I am not familiar with it.

Senator Michael D'Arcy: I thank Professor FitzGerald for his openness in the way he has come in and addressed the committee this morning, which is refreshing.

I wish to ask him about - we touched upon it earlier - the latent influence. We can see from Professor FitzGerald's reaction that when somebody picked up the phone to express dissatisfaction with an ESRI report, he was furious. He touched upon it earlier when he said that the former Taoiseach - I presume he means the former Taoiseach, Mr. Bertie Ahern - between 2005 and 2007 was very strong in his criticisms of anybody who had things to say that were negative towards the Irish economy.

Is there a different method of influence? If one takes the ESRI medium-term report in 2005, the Davy report by Rossa White in 2006 and the RTE programme in which Professor FitzGerald participated in 2007, is there a different way of influencing people who are either fully employed by the State, be it the regulator's office, Central Bank or the Department of Finance, or part-funded by the State? With that latent influence, if one says something that is perceived to be against the economy or against the workings of the economy, a different version of influence applies. I ask Professor FitzGerald for his opinion on that.

Chairman: Perhaps the question should be to ask Professor FitzGerald to comment on that.

Senator Michael D'Arcy: It is the same thing.

Chairman: Well it is but the Senator needs to say it not me.

Professor John FitzGerald: I am not clear on what the nature of the-----

Senator Michael D'Arcy: I am talking about the latent influence by people. If one has a criticism of the economy, a major player will come out and be very critical of that rather than picking up a phone and influencing a report in a different way.

Professor John FitzGerald: Obviously we have had lots of occasions when Governments have rejected what we have done. I have even had my wife, as Minister of State, reject our research. This is the world one lives in. Politicians have many advantages and they do not hold grudges - certainly my wife did not.

(Interruptions).

Professor John FitzGerald: There is another way, I suppose. If a number of people were looking for a job in the public sector, one says, "Oh, well if you-----", but, no, Ireland does not work like that. There is a groupthink where everybody thinks the same. There are serious problems with that especially in a small society, but latent influence, I am not clear that there is any. There will be overt influence which may or may not work; I do not think it does work. The influence which does work is when people come up with evidence which suggests a different conclusion. One's job is, even if one does not like the evidence, to go off and assess it, and change one's mind if the evidence is different.

Senator Michael D'Arcy: In Professor FitzGerald's opening statement he stated that by 2006 effectively the bubble was irreversible. In his opinion, at what stage were the banks insolvent?

Professor John FitzGerald: I do not know, but I think by the end of 2006 early 2007 I would have said there was a 50% probability of a collapse in the housing market with consequences. From what we know now, once one had a - perhaps - collapse then in the property market, one was going to have a banking problem. It would have been substantially smaller. The earlier the bust happened, the better from our point of view. It is a judgment; I have not done research on this. My feeling is that sometime around then it became irreversible and the costs were going to be very significant with the benefit of hindsight.

Chairman: I call on members to ask one final question each, starting with Deputy O'Donnell.

Deputy Kieran O'Donnell: When the AIB economists contacted Professor FitzGerald, did either he or the economists contact the Financial Regulator or the Central Bank?

Professor John FitzGerald: I do not know what they did, but I did not.

Deputy Kieran O'Donnell: Why not?

Professor John FitzGerald: Because-----

Deputy Kieran O'Donnell: Professor FitzGerald had a history of contacting the Central Bank.

Professor John FitzGerald: Because I provided information and it sounded as if AIB was going to do the job itself. It was when there was an accumulation of evidence, having seen over the course of the year, that I became concerned and said, "This is a systemic problem" and sought to talk to the Central Bank about it in 2007.

Deputy Kieran O'Donnell: Professor FitzGerald spoke about groupthink in Ireland. In terms of a society of our size, does he believe sufficient resources are being put into independent bodies coming up with retaining the integrity of those bodies? Does he think that the ESRI in terms of its structure was compromised in terms of its-----

Chairman: I ask the Deputy not to use the word "compromised". He could ask about effectiveness and whether it was operational.

Deputy Kieran O'Donnell: Does Professor FitzGerald believe there was any way in which, in terms of the effectiveness of the ERSI, it was not able to function in a truly independent manner?

Professor John FitzGerald: I think we were totally independent. I am happy about that, but I do not have a monopoly of wisdom. The ERSI does not have a monopoly of wisdom. In Germany, I have worked with five big institutes there - it is a much bigger society. The problem is their economies of scale. The institute does a very good job. When it was much smaller it was not as effective. It was set up because the universities were not producing useful research. We see now, say, the Nevin Institute - that competition is really good. How many research institutes of that kind one can support in a society is a problem.

Looking at, say, the Netherlands, the central planning bureau, which I think is the best in Europe, is in a dominant position, a monopoly, and they do a great job, but they are very conscious of the fact that they are in a responsible position. In the ESRI in the 1980s, one would publish something and nobody might notice. It has become much more of a responsibility when the media are going to take everything very seriously. It probably means that one is a bit more careful in what one does, which is probably a good thing, but in a small society, like Ireland, one is not going to have a multiple set of think tanks. I cannot think of any other country the size of Ireland or even larger which would have multiple ESRIs. However, one does need competition and one always needs to be aware that one does not have a monopoly of wisdom.

Deputy Joe Higgins: Professor FitzGerald said he advocated taxation on the interest that people who bought their homes would pay. That would increase an already heavy burden of repayments on ordinary working people who are buying homes, leaving aside the speculators, the portfolio assemblers, etc. Did you consider that perhaps those who were making massive profits on the other side of the equation were the ones who should be hit, in order to hit speculative profits etc.?

Finally, considering construction grew to almost one fifth of the economy, accounting for hundreds of thousands of jobs, was consideration given to the fact that the banks involved, the companies and the developers had massive economic power? Is it healthy for social ends that such power would exist in a few hands? Should that power not be in public ownership and under democratic control.

Professor John Fitzgerald: On the issue of the excess profits, particularly those accruing to land and property, it would be great to do something about taxing them. The problem is that where too much money is chasing too few houses, the money may be taken off the property developers and given to the State - which is a good thing - but we would still have the household sector massively in debt and exposed and the banking system which is funding it exposed. Therefore, taxing the profits was not going to prevent a bubble. It might have meant that some of the benefits of the bubble would have accrued to the State rather than to private individuals, but to stop the bubble, we need to stop people buying houses. That is the only way to do it.

There are different ways of doing that. My preference for a tax on interest payments is that it would make it more difficult for people to take out large loans. They would not be able to fund them and would end up less indebted. However, if we increase stamp duty, which is the mechanism suggested by the Treasury, people might end up more indebted. I am not hung up on a particular mechanism, but we need some fiscal mechanism to take money out of the property market. Taxing the profits will not do that. It will transfer the benefits from private individuals to the State, which would be great, but will not prevent a bubble.

Deputy Joe Higgins: Judge Kenny said, 40 years ago, that building land in urban areas should be subject to strict price control and so on.

Professor John Fitzgerald: In regard to the profits from rezoning, this area has been the source of a large incentive for corruption in Ireland. Also, why should the State confer large value on individuals just by a decision to rezone? There is an incentive for bad behaviour as a result. I totally agree with the Deputy that the profits from rezoning should be taxed, but that would not have solved this problem.

Deputy John Paul Phelan: I am going to ask one of the "discuss" type questions Senator Barrett mentioned earlier, because I do not want to be accused of asking a leading question. My question goes back to AIB. Early in 2006, senior economists within the AIB group approached Professor FitzGerald in regard to information on his analysis on the Central Bank stress tests and the professor subsequently had a meeting with them. I am asking the professor to put that on one side of the equation. On the other side, we have September 2008 and the night of the bank guarantee - on which the professor was not consulted - when senior people from AIB said they might have a liquidity problem, but they did not have a capital problem. Discuss that two and a half year period, when things would not have improved from an AIB point of view. Professor FitzGerald has indicated to the committee that the board may have had concerns at the start of 2006, such concerns that it came to him, but then, two and a half years later, when the crunch came, it appeared to say something different.

Chairman: With respect to Professor FitzGerald, he would have limited information as to what any bank would have been doing over a two and a half year period.

Deputy John Paul Phelan: That is why it is a "discuss" question.

Chairman: If there was a question, it might be: Had any of the financial institutions, in the lead up to the guarantee, engaged with Professor FitzGerald on what they saw or perceived or concerns they had in regard to an impending crisis?

Professor John Fitzgerald: No, but work we did in 2006 for PTSB in producing the stress scenarios - the macroeconomic scenarios - did raise one concern regarding a liquidity crisis. This was relevant as that is where the market would stop funding the banking system and the money. That was useful information, which should have helped build a picture of the dangers to the system.

On what the banks knew, I am very interested in the committee's work and I hope it can tell me. It looked to me as if there were people in AIB who were worried. How was it, when there were people in AIB who were worried - and probably people in the other banks - things turned out they way they did? I am waiting for this committee to answer that question.

Senator Susan O'Keeffe: Can Professor FitzGerald tell us how many banks the ESRI worked for during this period of time. He mentioned the approach made by AIB and mention was made of PTSB. Did the professor do work for others?

Professor John Fitzgerald: There are three cases where I provided macroeconomic scenarios, Ulster Bank, AIB and PTSB.

Senator Susan O'Keeffe: Was it macroeconomic advice that was provided?

Professor John Fitzgerald: What we did was ask what happens if housing prices fall by 30%. Unemployment goes up, Government tax revenue falls and it might have to raise taxation to plug the gap. We provided that information to the banks. That was in the public domain, but was slightly modified from what we had published. However, that information was essentially published.

Senator Susan O'Keeffe: Did that preparation involve Professor FitzGerald or his colleagues on the team looking at the bank figures?

Professor John Fitzgerald: No. We did not want to get involved. This was work which was in the public domain. It was slightly modified for the banks' needs, but we did not want to get too involved with the banks. I made it clear that we were not going to undertake the implementation of this in terms of how it would operate in the banks, that this was for them to do and that we did not want to be involved, but wanted to be independent.

Senator Susan O'Keeffe: Was Professor FitzGerald ever approached privately, as a professor as opposed to in his day job, to do work for anybody else?

Professor John Fitzgerald: Under my contract in the ESRI, anything I did, even something such as appearing with Marian Finucane, for which a fee is paid, is payable to the ESRI. We do not do independent work. We work for the ESRI and anything we do, such as being on the board of the Central Bank, and anything I am paid for that is sent to the ESRI.

Senator Susan O'Keeffe: Did Professor FitzGerald do any other work? I am not talking about moneys he may have been paid, but asking whether he did any other relevant work.

Professor John Fitzgerald: No. Anything I did, I did as John FitzGerald for the ESRI. If people approached me, they did it because I was in the ESRI. In most cases, it was much simpler if they paid the ESRI directly rather than pay me and I having to transfer that. I work for the ESRI and that is it.

Senator Sean D. Barrett: The macro prudential instruments we restored approximately two weeks ago existed in the past, probably before 1999. How did they disappear from the system, without anybody noticing, apparently?

Professor John Fitzgerald: I do not know. They should have been in operation. Up until 2009, I was uncertain as to their extent. First, I had not checked the legal powers of IFSRA and the Central Bank. One of my concerns about the banking crisis was the extent to which competition coming from foreign banks outside of Ireland drove Irish banks to do stupid things to hold their market share. One of the things I was not sure about was whether the Central Bank - I now know what powers it has and it has powers in this area - had power to regulate the banks. It could say it had powers to regulate AIB, because it licensed AIB, but did it have powers in regard to Ulster Bank or Bank of Scotland (Ireland)?

I asked Axel Weber, then governor of the Bundesbank, when he was in Dublin whether Europe needed more co-ordination. His formal answer was, "You just get on to the Financial Services Authority, FSA, in London and tell them what to do." Talking to him afterwards, it was clear that while that was the theory, had the Central Bank taken action it might have run into difficulties with the FSA saying it was being mean to British banks and it was a competition issue or whatever. Although I do not know how it would have operated in practice, they should have done it. Had they protected our banks, the ones that landed in our laps, we would not have the problem we have today. It was a failure of regulation. It is unclear how it would have operated in a world with banks from different countries with different regulators. That is why the achievement of European banking regulation is a great leap forward. I know that we failed, and that had we taken action we could have stopped it, but I am not sure of the details of how, precisely, it would have worked out.

Deputy Eoghan Murphy: I would like to clarify three points Professor FitzGerald made this morning.

Chairman: You have only a minute.

Deputy Eoghan Murphy: In his opening statement, Professor FitzGerald said, "The dangers the economy faced as a result of the over-inflation of house prices, the build-up of debt and the loss of competitiveness in the economy were foreseeable and [as set out in the appendix] foreseen." The appendix contains the implications for fiscal policy of the analysis in the ESRI quarterly economic commentary and the medium-term review in the period 2001 to 2008. He contends that the dangers the economy faced were foreseen by the ESRI and published over the period. Am I correct that Professor FitzGerald conveyed some of his warnings to the European Commission and the IMF and asked them to intervene with the Government, and they said they could not?

Professor John FitzGerald: Yes.

Deputy Eoghan Murphy: When the warnings were conveyed to the Department of Finance, the work of the person reporting on Professor FitzGerald's reports was amended internally so that it was not conveyed appropriately to senior level.

Professor John FitzGerald: I learned that only in the past year or two as a result of the operation of the media through freedom of information. I publish reports and would be normally totally unaware of what happens to them in the Department of Finance. This is all I know about what happens in the Department of Finance. The Deputy knows as much as I know.

Deputy Michael McGrath: Could I clarify the difference between the work Professor FitzGerald did for AIB, Ulster Bank and PTSB and the work he did not do for AIB subsequently? Was it that AIB wanted him to do stress tests as opposed to just framing macroeconomic scenarios?

Professor John FitzGerald: It is not clear to me that AIB wanted me to do it, but I was very clear that I was not going to do it. There was a line. I was prepared to do work that would be in the public domain. The ESRI does research to be published without censorship. My concern was that to do a private good which I would not be able to publish would be contrary to the remit of the ESRI.

Deputy Michael McGrath: What was AIB's specific request in early 2006?

Professor John FitzGerald: AIB just wanted the macroeconomic scenarios and I do not think either of the other banks wanted me to go further than that. They were not inviting me into the spider's web.

Deputy Michael McGrath: At the meeting when AIB expressed concern that there would be no stress test by the Central Bank, what was it with a view to doing?

Professor John FitzGerald: AIB wanted me to do specific macroeconomic scenarios for it, which it would then apply. I said I could do it, and AIB could pay the ESRI, but referred the bank's representatives to a CD that anybody could buy for €250 and which contained the scenarios it wanted. It bought the CD, and what use it made of it the inquiry can ask AIB.

Senator Marc MacSharry: I thank Professor FitzGerald for his honesty and candour. Given all that we know now and Professor FitzGerald's expertise, what course of action would he have recommended on the night of 30 September 2008?

Professor John FitzGerald: I would have recommended to the then Minister for Finance, and I subsequently recommended, that he go and talk to Patrick Honohan. I have a DVD of what Patrick Honohan said on the Vincent Browne show two days later and his lecture, which was that while it was not the best outcome for Ireland, something had to be done. He was the international expert, not part of the administration. Had he been consulted, there would have been a different outcome.

Chairman: I will bring matters to a conclusion. The task of this inquiry is not just to examine the past and identify system failures or problems or discuss probabilities during that time but also to look to the future and ensure future modelling of financial assessments and risk are better dealt with. What lessons about modelling and forecasting in the Irish economy can be learned from the crisis? What assessment have the ESRI and Department of Finance made of these areas in recent years? Would Professor FitzGerald recommend anything else to the committee?

Professor John FitzGerald: As I said, the fact that nobody has a monopoly on wisdom is important. The Government should encourage diversity of opinions. Undertaking research across a wide range of areas of the economy is important. Models need to develop continuously. Although we will soon have a model of the financial sector, the next problem to hit Ireland will be something different. How do we know what it will be? We should not be too reliant on the past and should think outside the box, and this is one area in which we have failed. I do not know what will be the next major policy challenge.

In fiscal policy, I am concerned that we lack the infrastructure to sensibly operate the rules we have put in place regarding the management of fiscal policy and structural deficit, and which are embedded in the Constitution. As long ago as the early years of the last decade, the Department of Finance said the current EU methodology for calculating the structural deficit and potential output was an unwise method. Although the methodology was telling the Government it was doing a great job and should continue to stimulate the economy, the Department of Finance still said it was a bad method. Whereas the European Commission is now saying Ireland has a substantial structural deficit and needs more cuts, my assessment, using my methodology published last April, is that we are in structural surplus and do not need further cuts. However, in the medium term, using an appropriate methodology, we may find ourselves in the next five years having to run an increasing surplus because there is a chance we might get rapid growth, moving beyond potential output. There is a need to improve our methodology and we have put forward a methodology for assessing fiscal policy which is better than what is there.

The European Commission officials accept that the methodology does not work. In 2010 and 2012, I was at conferences in Amsterdam and Brussels, and at the Amsterdam conference my colleague spoke about this problem, that the methodology is inappropriate. The European Commission official became furious, not because my colleague had said the methodology was wrong but because she had said it was a Commission methodology. The official's view was that it was an EU methodology and that, although the Commission implemented it, he agreed with us. In monitoring fiscal policy, we must develop more appropriate methodology that will give the right answer. There is a danger that in the short run it may tell us we need €2 billion more in cuts when we do not, and that in the long run it may tell us to stimulate the economy when we should take money out of it. I have suggested a methodology. I do not have a monopoly on wisdom and it is open to the Irish Fiscal Advisory Council, IFAC, the Department of Finance and the ESRI to develop an alternative. We need better guidance for the future in light of the mistakes of the past.

Chairman: I thank Professor FitzGerald for his participation in today's meeting. It has been very informative and valuable and has added to our understanding of the factors leading to the banking crisis. On behalf of the committee, I thank Professor FitzGerald for the extensive time he has given to the committee this morning and the preparation he put in beforehand. I know he did a lot of preparation work.

The joint committee adjourned at 1.20 p.m. until 9.30 a.m. on Wednesday, 18 February 2015.