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AN COMHCHOISTE FIOSRÚCHÁIN I DTAOBH NA GÉARCHÉIME BAINCÉIREACHTA

JOINT COMMITTEE OF INQUIRY INTO THE BANKING CRISIS

Dé Céadaoin, 18 Feabhra 2015

Wednesday, 18 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

Mr. Marco Buti

Chairman: As we have a quorum I call the meeting to order. We will proceed with session one of this morning's business, which is a public hearing discussion with Mr. Marco Buti, Director-General for Economic and Financial Affairs. I welcome everyone to the ninth public hearing of the Joint Committee of Inquiry into the Banking Crisis. Later this morning we will hear from Dr. Donal Donovan, former IMF deputy director. At the first session this morning we will hear from Mr. Marco Buti from the European Commission on the international, EU and domestic policy context of the banking crisis in Ireland and, in particular, the European Commission's role in monitoring the Irish economy in the years prior to the crisis as part of the stability and growth process. Mr. Buti, you are welcome to the meeting and I would also like to acknowledge the Commission's positive engagement with this inquiry and for your co-operation this morning. The committee would like to put that on record.

Mr. Marco Buti has been Director-General for Economic and Financial Affairs at the European Commission since December 2008. After completing studies at the University of Florence and the University of Oxford, Mr. Buti joined the European Commission in 1987. He was an economic advisor to the Commission's President until 2003. From September 2003 to August 2006 he was Director for Economies of the Member States at the Directorate General for Economic and Financial Affairs where he was appointed Deputy Director-General in September 2006. Mr. Buti has also been a visiting professor at the Université Libre de Bruxelles, the University of Florence and the European University Institute, and has published extensively on EMU macroeconomic policies, welfare state reforms and European unemployment.

Before I begin I would advise witnesses that by virtue of section 17(2)(*l*) of the Defamation Act 2009 witnesses are protected by absolute privilege in respect of their evidence to this committee. If they are directed by the Chairman to cease giving evidence in relation to a particular matter and they continue to do so, they are entitled thereafter only to qualified privilege in respect of their evidence. They are directed that only evidence connected with the subject matter of these proceedings is to be given and they have been informed previously that the committee is asking witnesses to refrain from discussing named individuals in this phase of the inquiry. Members are reminded of a long-standing ruling of the Chair to the effect that members should not comment upon, criticise or make charges against a person outside the Houses or an official by name or in such a way as to make him or her identifiable.

With that said if I can invite Mr. Buti to make his opening remarks and we will then move on to questions. Thank you very much, Mr. Buti.

Mr. Marco Buti: Thank you very much, Mr. Chairman. It is a real pleasure to be here in Dublin and an honour to have been invited to appear before this committee and its inquiry into the banking crisis. I have prepared quite a comprehensive statement. I will go through that because it sets out the framework for what the European Commission did at the time and how it read the challenges of the Irish economy before the crisis.

I have been asked to deliver a statement on the role of the European Commission in the Irish economy in the years prior to the crisis. I will structure my statement in two parts. The first part will focus on the economic development in the run up to the crisis, both international and

domestic. In the second part, I will review the role of the European Commission in economic surveillance at that time.

When analysing economic growth in Ireland before the banking crisis, it is useful to distinguish two different periods, from the early 1990s until 2000, and from about 2001 until the bursting of the housing bubble in 2007. The first period is often referred to as the Celtic tiger period. It was a period of extraordinarily strong growth. The annual increase in real GDP averaged 7.2% as opposed to just above 2% in the euro area. As a result there was an impressive and unprecedented convergence in living standards. In 1990 gross national income per person stood at around 60% of the euro area average; ten years later it was already above the Euro area average. In the 1990s economic growth was led by exports. Ireland was able to take advantage of the single European market and globalisation. It raised exports in high value sectors such as computers and pharmaceuticals. Thanks to a flexible and English-speaking economy, Ireland attracted significant FDI inflows which boosted productivity growth and enhanced competitiveness. The current account recorded an average surplus of 1.6% in the 1990s. During this period employment growth was brisk with minimal wage pressure since unemployment was relatively high, female participation in the labour force low, and net inward migration flows increased the labour force. The unemployment rate fell from 13.4% in 1990 to 5.6% in 1999. Fiscal adjustment taken in the late 1980s to tackle the very high stock of public debts supported this expansion. Government spending restraint and salary agreements also underpinned wage moderation.

In the 1990s inflation was low, on average 2.3%, close to the average record in the Euro area as a whole. General Government debt fell by half to around 47% of GDP. The year 2000 marked the end of the ICT boom which had pushed growth rates in Europe and the US close to 4%.

By then, Ireland's real economic growth was close to 10%, wages were rising by more than 13% and annual inflation exceeded 5%. From about this point until the onset of the Irish banking crisis there was a striking shift in the Irish economy. The overall growth momentum remained strong, but became largely reliant on domestic demand. Between 2001 and 2007, real GDP growth averaged 5%, as opposed to close to 2% in the euro area. Average inflation increased to above 3%, while it stayed slightly above 2% in the euro area as a whole. Ireland had reached full employment. Wage pressure began to emerge and competitiveness deteriorated, with tight labour conditions.

Subsequently, export growth began to wane and export market share fell. The current account balance deteriorated and by 2007 it recorded a deficit of about 5.4% of GDP. Economic growth became increasingly reliant on construction. Interest rates had declined substantially and access to credit increased with Ireland's entry into EMU. This helped to trigger a boom in investment in housing and commercial property, with rapidly rising property prices. The positive wealth effects from rising housing prices also contributed to buoyant private consumption.

By the mid-2000s, the construction sector, especially its residential housing component, had become very large. Construction investment grew to about one fifth of GDP, the highest in the euro area. Employment growth also became increasingly reliant on the construction boom and the rate of unemployment fell to 4.4% in 2005. The proportion of those employed in construction peaked at an unprecedented level of about 13.5% in 2007. The construction sector benefited from strong inward migration flows, particularly from EU enlargement countries in 2004.

Nonetheless, the labour market remained tight, pushing up wages. The reallocation of re-

sources into the housing sector, which was traditionally labour intensive and employed low-skilled workers, left limited room for improving productivity. House price inflation surged in Ireland and rose more than fourfold between 1993 and 2007, among the highest of any advanced economies.

On the demand side, demographic trends, higher disposable incomes, lower real interest rates and easier access to mortgage finance supported the booming property market. Government policies also played a role through the favourable tax treatment of housing, such as the deducibility of mortgage interest payments. The supply of housing also rose sharply, but eventually beyond the needs of the population. The idea that house prices would increase forever turned into a recurrent and dangerous motive.

One of the main factors which fuelled the housing boom was the rise in private sector credit. The private sector debt-to-GDP ratio rose to over 200 % by 2008. As the bulk of credit was supplied by banks, this led to a major expansion in banks' balance sheets. There was an increase in competition among the banks with many new entrants into the market, lending standards weakened and average loan-to-value ratios increased significantly. Lending to households and property developers soared, boosting private sector debt levels. Domestic banks also engaged in a rapid expansion of foreign activities. At the end, the Irish banking sector was severely oversized relative to the size of the local economy and the fiscal capacity of the Irish sovereign.

The lending boom by the Irish banks was facilitated by the international context during this period. Banks increasingly funded themselves easily on external wholesale markets as cross-border financial flows boomed in the international financial system, supported by low global interest rates. Moreover, EMU had eliminated currency risks within the euro area and this contributed to rising cross-border borrowing. As credit expanded faster than deposits, Irish banks became increasingly dependent on international market funding, leading to an unbalanced funding structure. This left banks vulnerable to the eventual tightening in international capital markets. Ireland was not the only such case; similar developments took place within the euro area in Spain.

The role of the Irish financial supervisor and regulator during the boom years has been extensively analysed and assessed by many observers. I understand there have been dedicated sessions on this issue in this forum. I, therefore, do not intend to elaborate at length. It may suffice to say that I agree with those who conclude that the domestic financial supervisor did not acknowledge and address the risks associated with the credit and housing boom. I also believe that the supervisors in the originating countries share some of the responsibility, but this is not to detract from the primary responsibility of the domestic supervisor, which has been widely acknowledged in Ireland.

More generally, supervisors in a number of member states did not seem to care sufficiently about the risks of rapid year-on-year loan growth, the increasing concentration of investment in the construction sector and the relative size of their banking sectors compared to GDP, and Ireland is probably the most extreme example of what can happen when these problems are ignored. More generally, supervisors in many member states were concerned almost exclusively with micro-prudential supervision, that is, checking the soundness of individual banks, and there was insufficient attention placed on macro-prudential supervision, that is, risks to the financial system as a whole.

The housing and lending boom also impacted Irish public finances. Government spending rose sharply as a percentage of GDP, financed by the additional tax revenues linked to the

housing boom. The budget was in surplus as of 2003 and the general government debt declined to a low of 24.6% of GDP in 2006. We know that the structural budget balance, that is, the balance net of temporary components, was expansionary and contributed to the overheating of the economy. Revenues became overly reliant on the property market and the income tax base shrank due to successive tax cuts. This left the budget exposed to the ensuing downturn in the property market.

I have given the committee our assessment of the most important economic developments in Ireland in the years preceding the crisis. Let me now move on to how economic surveillance was implemented at the EU level during the boom period. I will start with the surveillance instruments that were available prior to 2007 and then move on to the question of how they were used in practice.

The European Commission acts as the guardian of the EU treaty. Within this general mandate, the Directorate General for Economic and Financial Affairs is the service in charge of economic policies. It carries out its duties, under the supervision of the competent member of the Commission, by monitoring and assessing economic developments in the member states, reporting on the findings of our assessment to member states directly and to the public at large and initiating specific surveillance procedures for member states where economic developments move outside or risk moving outside the perimeters laid down in EU legislation.

In the pre-crisis years, the EU framework for economic surveillance was a reflection of the principles enshrined in the Maastricht treaty. The treaty, which entered into force in 1993, laid the foundations of the economic and monetary union. Monetary policy was entrusted to the ECB while fiscal policy remained a prerogative of the member states, but to be carried out in line with commonly agreed rules.

The treaty also included a general provision, according to which member states "shall regard their economic policies as a matter of common concern and shall coordinate them within the Council". In the years following the entry into force of the Maastricht treaty, the EU strengthened fiscal surveillance via the Stability and Growth Pact. The same did not happen to structural policies. This asymmetry was not an oversight. It was a reflection of the macroeconomic paradigm prevailing at the time in Europe and beyond.

This paradigm, sometimes referred to as the "great moderation", reigned until 2007, the onset of the most severe economic and financial crisis in post-Second World War history. According to the great moderation paradigm, overall macroeconomic stability was to be ensured by meeting two overarching conditions; one, low, steady inflation and, two, prudent and sustainable fiscal policy. Experience in advanced economies since the late 1980s corroborated this view especially when compared to the more unstable 1970s and early 1980s. Countries that kept their fiscal houses in order with inflation reasonably low and stable followed a relatively small path of macroeconomic development. Other macroeconomic compartments such as the financial sector, house price developments or the current account were not thought at the time to create major problems of their own. They were expected to be restrained by prudent monetary and fiscal policies. Today, we know this is not the case, but until 2007 the focus on macroeconomic surveillance in the EU was clear. The ECB looked after price stability with a very strong mandate and the European Commission monitored national fiscal policy making against the parameter of the Stability and Growth Pact, SGP.

There was also an instrument to co-ordinate economic policies beyond public finances, the so-called broad economic policies guidelines. However, this instrument amounted to soft co-

ordination with no enforcement power. With benefit of hindsight, there is little consolation to be gained from the fact that not only Europe followed the great moderation paradigm in implementing monetary economic policy. It is important to underline that, with very few exceptions, the economic profession at large relied on this paradigm.

In the case of Ireland, how was the EU economic surveillance framework applied in this country in the years preceding the 2007 onset of the crisis? I will start in 2000 for three reasons. First, the SGP entered into force only in the late 1990s. Only since then can we speak of a functioning EU fiscal surveillance framework. Second, the early 2000s coincided with the onset of the second and less healthy part of the catching up process in the Irish economy. Third, in 2000, the Irish Government adopted a draft budget for 2001 which brought Ireland onto the Commission radar screen for the first time, signalling potential macroeconomic problems. Against this backdrop of clear signs of overheating in the Irish economy, budget talk was expansionary and risked adding fuel to the fire. On Wednesday, 24 January 2001, the Commission issued a critical opinion on the 2001-2003 stability programme. It concluded the Irish fiscal policy was inconsistent with the broad economic policies guidelines adopted by the European Council six months earlier. Those guidelines had asked Ireland to avoid further overheating of its economy by containing public expenditure. In parallel to the critical opinion on the Irish problem, the Commission also recommended to the Council to ask the Irish Government under article 99(4) of the Maastricht treaty to take countervailing measures in the course of 2001. The ECOFIN Council adopted the recommendation on Monday, 12 February 2001. As some of you may remember, the recommendation was not very well received in Ireland at the time and it was not implemented. Many in the economic profession derided the Commission, accusing us of focusing more on decimals rather than acknowledging the strength of the Irish economy.

As guardian of the treaty, the Commission played its role well, based on the information available at the time. There was a clear inconsistency between the Government's budgetary plans on the one hand and the economic policy guidance endorsed by the European Council on the other. Picking up on this inconsistency, and within the existing surveillance framework, the Commission put in motion the relevant wheels and the Council followed. At this point, I should stress that all EU surveillance documents, including the Commission technical assessment, the stability programmes updates, the Commission recommendation for a Council opinion and the Council opinion, are all available on the website of the DG.

In retrospect, the assessment of whether the 2001 Council recommendation to Ireland was a good idea or not is less clear cut, even controversial. As we know, the ICT bubble burst in the course of 2001, triggering a sharp economic slowdown in the US and Europe. Ireland was also affected. Quarterly GDP growth moved from more than 13% in question one of 2001 to almost stagnation in question four. With the Irish economy cooling off so abruptly, the Council's call for a tighter budget to avoid overheating did not seem particularly appropriate any longer. Later in 2001, when the assessment of the 2002 budgets and stability programme updates were due, the Council reviewed its assessment. On a recommendation from the Commission, it issued an opinion that approved the budget plans of the Irish Government. The Council still urged Ireland to aim for a neutral fiscal stance. However, the assessment no longer raised any major issues. The case of the 2001 recommendation under Article 99(4) of the treaty for Ireland was closed.

At the time, the Commission was right in stressing the need to avoid a pro-cyclical fiscal expansion in a boom period, even if due to the unexpected burst of the ICT bubble the recommendation turned out to be ill-timed. In the subsequent years, the Commission did not shy away from taking a critical view of Irish fiscal policy-making. On the contrary, the annual tech-

nical assessments of the Commission of the successive stability programme updates regularly expressed concerns about strong Government expenditure growth and only moderate budgetary improvements in the face of a solid economic recovery. In the years after 2001, Commission recommendations for a Council opinion on the Irish stability programmes consistently urged Ireland to strictly control public expenditure, including through the implementation of an effective expenditure framework. The first such call was already included in the 2002 Council opinion, but did not fall on fertile ground in Ireland. Helped by the growing influx of revenue from the housing boom, the Government successively increased expenditure and lowered taxes.

As the Government deficit remained below the Maastricht limit of 3% of GDP, the post-2001 Council opinions did not identify any formal conflict with existing EU fiscal rules. At the same time, the Commission assessment did indicate a few points which, with the benefit of hindsight, turned out to be crucial. For instance, the Commission regularly stressed the uncertainty surrounding estimates of the structural budget balance for the Irish economy - that is, the budget balance net of temporary components. After 2002, the Commission noted several times that the Irish Government's targets for the general government budget balance may not have been particularly ambitious in view of the very solid recovery of economic growth. Underlying this message was the sense that the structural fiscal position was weaker than the official estimate suggested, but there was no way to substantiate this view. The method agreed by the ECOFIN Council in 2002 to estimate the structural budget balance for the purposes of EU fiscal surveillance did not signal any specific problem for Ireland.

The second point the Commission underlined clearly in its post 2001 assessments was the strong contribution of construction to economic growth. In its 2005 assessment of update of the Irish stability programme, the Commission identified the very high valuation of existing housing stock and a possible sharp downturn from the extended residential construction boom as a downside risk to the economy and public finances. A year later, the Commission's assessment of the 2006 update explicitly referred to unsustainable levels of residential construction. Together with very high residential property prices, the construction boom was thought to carry the risk of a sharp downward adjustment in the wider economy.

Then again, the identification of risks linked to the construction boom did not translate into concrete surveillance actions. The EU economic surveillance framework at the time was centred on public finances and Ireland complied with existing rules. I am not trying to argue that the Commission saw everything coming, but could not do anything. What I am trying to say, however, is that the Commission did, within its remit, pinpoint issues which in retrospect turned out to be important, but then, even if we had anticipated the end of the economic boom and the beginning of a collapse in Ireland before 2007, we would not have had the legal tools for asking Ireland to take any corrective measures. However, the lack of legal instruments was not the real constraint for EU surveillance. The real constraint was our limited understanding at the time of what could really endanger overall macroeconomic stability. Yes, we understood that the Irish housing boom would not be sustainable, but in line with the great moderation paradigm, we, as others, did not anticipate that the end of the housing boom could give rise to the dislocations that eventually emerged after 2007 which later led Ireland to ask for financial assistance from the EU and the IMF. The financial sector was thought to simply channel funds in an efficient manner to where the real economy needed them. Dangerous excesses were thought to originate only in monetary and fiscal policy making. This is evidenced by the fact that between 2001 and 2007 no Commission assessment of the Irish stability programme updates reviewed developments in the banking sector. Assessment of financial stability was not part of the broad economic policy guidelines process. Financial stability risks were mainly thought to be an

issue for individual banks, not for the economy as a whole. Moreover, financial supervision was a national prerogative. My colleague Mr. Mario Nava, who came before the committee earlier this month, clarified this point. He stated that in the 2000s the EU regulatory framework followed a principle-based approach that was embodied in the principle of minimum harmonisation. National supervisory authorities were responsible for applying and enforcing the minimum prudential requirements set out in EU directives. We worked under the assumption that national supervisors and regulators would be well equipped to address any nascent stability issues in the banking sector. We assumed they would do their job in a conscientious manner.

The post-2007 financial and economic crisis showed us the hard way that our conceptual framework of the macro economy was incomplete. Ireland was a particularly drastic example, albeit not the only one. The sudden drop in residential house prices undermined the viability of most Irish banks and exposed a striking lack of supervisory and regulatory rigour. The Government had to step in with its deep pockets to stave off the collapse of the financial sector and the economy as a whole. Later, the Government's pockets had to be filled with international financial assistance as access to financial markets at sustainable rates had been lost. The rest is now history. At the end of 2013, Ireland successfully completed the EU-IMF financial assistance programme. While important challenges remain, the country is back on track towards balanced and sustainable growth.

As regards EU economic surveillance, the post-2007 financial and economic crisis has not been wasted. As you are aware, the EU immediately launched an important and far-reaching reform process to upgrade and complete its economic governance structure. First, the EU surveillance framework has been strengthened with the so-called six-pack. Secondly, the scope of EU surveillance has been extended to include all relevant instruments beyond public finances; this was achieved with the introduction of the macroeconomic imbalances procedure. This was also part of the six-pack initiative. Since 2001 the Commission has consistently monitored member states with imbalances in all areas of the macro economy. Third, the banking union was introduced, including in particular the Single Supervisory Mechanism and the Single Resolution Mechanism.

It would go beyond the scope of my intervention today to go through the details of all these institutional innovations and what they meant for EU economic governance. My colleague Mario Nava outlined the regulatory response at the EU level to the crisis. It may suffice to say that they constitute a major step forward. I am convinced they will help us not to repeat the mistakes of the past. I apologise for the length of my statement. Thank you for your attention.

Chairman: Thank you very much, Mr. Buti. Just to get matters under way, the questioners this morning will be Senator Marc MacSharry and Senator Susan O'Keeffe, followed by Deputies John Paul Phelan, Eoghan Murphy, Joe Higgins, Kieran O'Donnell, Pearse Doherty and Michael McGrath, and Senators Sean Barrett and Michael D'Arcy.

Can Mr. Buti clarify how his role is different from that of the European Commissioner for Economic and Monetary Affairs and the Euro, the position previously held by Olli Rehn and currently held by Pierre Moscovici?

Mr. Marco Buti: We are responsible at the technical level. We respond to the Commission, and to the college of Commissioners; with the new structure of the Commission, we also respond to the Vice Presidents in charge of economic policy co-ordination, Vice President Dombrovskis and Vice President Katainen. We supply the technical analysis and we provide our assessment. The actual recommendations addressed to the Council and to the member states are

approved by the college of Commissioners under the proposal of the Commissioner in charge. So there is a distinction here between technical and analytical responsibilities - and this is an equi-mandate responsibility - and the actual economic policy recommendations which pertain to the college of Commissioners and to the Commissioner in charge.

Chairman: Mr. Buti said the Commission would not have had the legal tools to ask Ireland to take any corrective action; in that regard, in the absence of enforcement powers, what steps should the European Commission have taken in relation to non-fiscal policies across member states?

Mr. Marco Buti: At the time we had a very limited set of tools. Within the Stability and Growth Pact we focused essentially on two conditions, a general government deficit limit of 3% and a debt limit of 60%. Within the broad economic policy guidelines we could go beyond that, and we did, as I indicated, in 2001, but with unfortunately no enforcement powers. So we signalled a number of risks emerging. I think we called on Irish authorities to behave responsibly but we did not have at the time any enforcement mechanism. What we did, and what we have to do for all member states, is to conclude whether the updates of the stability programmes of Ireland and other member states formally complied with the principles and constraints of the Stability and Growth Pact. In the case of Ireland it is clear that throughout the period the former requirements were abided by.

Senator Marc MacSharry: I welcome Mr. Buti and thank him for taking the time to be with us. Can I ask Mr. Buti if there was a policy, written or otherwise, within the European Commission, that no bank should fail?

Mr. Marco Buti: There was never a recommendation on the part of the Commission on that subject. It was not addressed to the Irish policy makers. It was not addressed to any other country or institution. You will not find in our opinions or our recommendations, either on the stability programmes or national reform programmes, a recommendation of this sort.

Senator Marc MacSharry: To rephrase that, I know there is not a written policy, because if there was I would have it, but was there an established doctrine among you and your colleagues as Directors General within the Commission, and the Commissioners, that it would be best that no bank should be permitted to fail?

Mr. Marco Buti: No. I do not think there was this type of unwritten rule or implicit preference. As I indicated, throughout the pre-crisis period, and I understand we are focusing here essentially on that period - that is, before 2007 - our focus was essentially on fiscal and macroeconomic policies. I said clearly in my statement that between 2001 and 2007, in the various assessments of Irish documents, we never focused on the banks. In retrospect, I admit this was a failure. It was a problem, clearly.

Senator Marc MacSharry: This was a failure. Was there a contingency considered by the Commission if, for example, Ireland or any member state allowed a bank to fail?

Mr. Marco Buti: I think the issue was not part of our surveillance at the time. As I indicated, the focus was essentially on the fiscal, the monetary and the macroeconomic. As I have indicated, it was thought that in line with the great moderation paradigm, banks and financial systems would simply help to allocate resources in the most efficient way to the economy as long as fiscal and macroeconomic policy remained disciplined. Monetary policy was to remain in line with the price stability objective and fiscal policy was to remain in line with the con-

straints of the Stability and Growth Pact. This was the paradigm at the time. We know today that the focus was only partial, unfortunately. Since then, we have completed our set of tools. The focus of attention has moved well beyond these two elements - monetary and fiscal - to encompass the banking system as well. We have gone well beyond that with the creation of the banking union.

Senator Marc MacSharry: Just so we are absolutely clear, no contingency was considered if a member state allowed a bank to fail. Mr. Buti said in his statement that "the European Commission acts as the guardian of the EU treaty". I suggest that if a bank were allowed to fail, that might have implications for the European treaty. Was no contingency considered by the Commission?

Mr. Marco Buti: During the whole pre-crisis period, banks were considered to be well capitalised and solid. No particular problem was emerging in that period. As I indicated in my statement, and as Mr. Nava told this committee two weeks ago, responsibility for financial supervision and regulatory matters was at the national level and not at the European level. The principle of minimum harmonisation prevailed at the time. The responsibility was at the national level. The supervisors were national. There was minimum co-ordination at the time. The remit or responsibility of the EU did not extend to following up on these matters. We have amended the view and the framework since then with the six-pack, the two-pack, the banking union and the whole regulatory framework on the banking side.

Senator Marc MacSharry: Did the Commission have a contingency in the event of a sovereign default from a member state?

Mr. Marco Buti: When we entered monetary union, the basic co-ordination rules were enshrined in the Stability and Growth Pact and monetary policy was attributed to the European Central Bank. At the time, we did not have the full set of tools that was put in place later on. I refer to firewalls like the European financial stability facility and the European Stability Mechanism that have been put in place to help countries in trouble. We had the no-bailout rule which was enshrined in the treaty. At the time, this was considered to be sufficient to deal with these matters.

Senator Marc MacSharry: Okay. We are clear now that there was an incomplete set of tools. In Mr. Buti's own words, that was a mistake and a failure, with the benefit of hindsight. Is that fair?

Mr. Marco Buti: I think it is well understood by now that economic and monetary union was created and evolved over time. We did not have all the tools we have now. I think we have paid the price for that. The firewalls which were put in place when the sovereign debt crisis erupted were not there in the first place in the Maastricht treaty. This is clear. I think we are better equipped now because we have the firewalls with the European Stability Mechanism, and with the European financial stability facility before. They were also deployed in the case of the assistance that was given to Ireland.

Senator Marc MacSharry: Could the limited tools that the Commission had at its disposal have been better used in the context of the crisis here?

Mr. Marco Buti: I understand we are not talking here about the crisis period per se.

Chairman: We are talking about the period leading up to it.

Mr. Marco Buti: I will talk about the pre-crisis period. Perhaps the committee will allow me to do a conceptual exercise. I will consider what would have happened if the tools available to us now had been available in the years before the crisis. Could they have helped us in preventing this?

Senator Marc MacSharry: I do not want to waste Mr. Buti's time or that of the committee of inquiry. That is not the question.

Chairman: I might make an interjection at this point. Mr. Buti is very clear in his engagement with the committee. He understands that he may discuss the period leading up to the crisis period, rather than the crisis period itself. I will correct Senator MacSharry if he drifts into that area.

Senator Marc MacSharry: I appreciate that.

Chairman: Perhaps the Senator might want to apply his question so that it relates specifically to whether mechanisms, firewalls and safeguards were in place and in the power of the Commission in the lead-up to the crisis period, but were not applied. I think that is the question he is asking. It has been asked. Maybe Mr. Buti can answer that and then we will go on to the Senator's next question.

Mr. Marco Buti: I will refer simply and very quickly to the macroeconomic imbalances procedure that is now available as part of the so-called six-pack. In the specific case of Ireland, four or five indicators would have flashed up in 2003 and 2004 on the scoreboard of indicators that we use to detect a macroeconomic imbalance. Those indicators might have related to housing prices, credit growth and loss of competitiveness in terms of real exchange rate developments, etc. We did not have this procedure at the time. If it had been available, we would certainly have put strong monitoring tools on Ireland and signalled the problem. Unfortunately, we did not do that because it was not part of the focus of economic monitoring under the great moderation paradigm.

Senator Marc MacSharry: Can I move on from that? It is unfortunate that we are not dealing with the period right up to 2010. I think it would be in the public interest, and in the interest of the inquiry, if preconditions were not set on people who are coming to give evidence. I do not think it is in the people's interest.

Chairman: I can be very clear here. We had briefing sessions yesterday afternoon as part of our preparations for Mr. Buti's appearance before the committee.

Senator Marc MacSharry: Yes.

Chairman: If we want to go into that debate, we certainly can now. I would not be putting out the impression that preconditions have been set. This inquiry is going to be quite extensive in covering a number of areas.

Senator Marc MacSharry: That is fine

Chairman: Could I ask Senator MacSharry to revert to the purpose of Mr. Buti's appearance before the committee this morning and refer his questions in that regard?

Senator Marc MacSharry: I will. I am merely pointing out that it is difficult to get the whole truth, as the people might desire, if we are accepting preconditions from witnesses in advance. It is worth putting that on the record.

Chairman: I would ask the Senator to-----

Senator Marc MacSharry: Moving on, can I ask-----

Chairman: Excuse me, Senator MacSharry.

Senator Marc MacSharry: Yes.

Chairman: The Senator might be applying an aspersion with regard to a witness before this inquiry this morning, to the effect that he is operating in a way that is ambivalent or antagonistic towards this inquiry. I do not think that is actually a fair comment. Mr. Buti is very clear in the role for which he is here this morning. This committee is very clear in the role for which Mr. Buti is here this morning. The preparation work that was done by this committee, particularly in the extensive briefing last week, was clear about the realms we would be covering with Mr. Buti. This inquiry will be dealing extensively with matters right through the crisis period, and the strategies applied to it, as we move into the nexus phase. Mr. Buti is here for a particular purpose this morning. That is the role of the agency and position he had within the Commission in the pre-crisis period. Questions should be asked in that regard.

Senator Marc MacSharry: As I live in the here and now, I cannot help being influenced by current events when I am framing questions and looking back on the pre-crisis period. With that in mind, I could not help noticing in recent days that tax anticipation notes were pointed out during the ongoing negotiations on the Greek situation as a potential remedy to the difficulties being experienced in that country. I accept that this was not agreed.

Chairman: I would appreciate it-----

Senator Marc MacSharry: If I could finish-----

Chairman: Sorry Senator-----

Senator Marc MacSharry: I will make it relevant.

Chairman: I have to advise the witness here. He is very clear on why he was invited before the committee this morning.

Senator Marc MacSharry: My question relates to the pre-2008 period.

Chairman: If questions-----

Senator Marc MacSharry: My question relates to the pre-2008 period.

Chairman: I will bring the Senator back in.

Senator Marc MacSharry: I hope the Chairman will allow for the time he is taking up as well.

Chairman: I am advising the witness, which is my responsibility as Chair, because there are very clear terms of reference and we have legal responsibilities for this inquiry, particularly to witnesses coming before it. Mr. Buti, if questions move outside the purpose for which you are here, if you believe those questions are not within your competence to answer and if you believe you cannot provide a proper answer to this inquiry, I will leave that to your discretion as to how you wish to pursue that question.

Senator Marc MacSharry: As the Chairman said, if any answers are not within Mr. Buti's competence or he does not want to answer them, he should just point that out and we will know. As I was saying, I could not help noticing in recent days the consideration of tax anticipation notes as a suggestion from the Greek authorities as they seek to deal with their issues. There is no agreement and we all wish them well, I am sure. In the pre-2008 period, would consideration have been given at that time to measures such as tax anticipation notes as an assistance tool for a sovereign government within the EU in a banking crisis rather than the prescription of austerity as a budgetary approach?

Mr. Marco Buti: May I ask what the Senator means by tax anticipation?

Senator Marc MacSharry: A tax anticipation note is something that has been suggested by the Greek Finance Minister in recent days. They are used at state level in the United States as a kind of IOU. If a state in America is in difficulty, it can say on the basis of tax that is going to be paid in the future that money will be ring-fenced to pay that debt. I believe that was the suggestion put forward by the Greek authorities in recent days. I am not talking about the current situation; I am talking about pre-2008. Were there alternatives? Had the Commission's range of thought processes and considerations considered contingencies such as this, rather than the blunt instrument which may be the prescription of austerity and budgetary cutbacks?

Mr. Marco Buti: With due respect, in the pre-2007 and 2008 period, the issue was not austerity, rather, it was insufficient fiscal discipline which eroded the space for budgets to respond and have sufficient room for manoeuvre when the crisis hit the country. It was not an issue of this sort. The kind of surveillance we had at the time focused essentially on headline deficits, which was amply satisfied in terms of the constraints because of the very strong growth and tax elasticities. There was an erosion of fiscal prudence underlying the behaviour of the country.

Senator Marc MacSharry: So there was no consideration given to this kind of thing.

Mr. Marco Buti: No, I think it was irrelevant at the time.

Senator Marc MacSharry: I am only at 13 minutes and I have a stopwatch on.

Chairman: I have a watch here. You are on 15 minutes.

Senator Marc MacSharry: You used about three of those.

Chairman: I did, because I am operating the rules of the inquiry.

Senator Marc MacSharry: You could be reasonable.

Chairman: I am giving you an extra bit of time, but you are over time at the moment.

Senator Marc MacSharry: When asked by me if the crisis could have collapsed the euro, your predecessor, Klaus Regling said, "Yes". Professor Bill Black, in testimony here, said: "Ireland tried to bail out the German banks." Professor Ed Kane said, in testimony here: "Ireland seemed to help creditors in foreign lands like Germany." Mr. Buti said in his statement that the post-2007 financial and economic crisis showed us the hard way that our conceptual framework of the macroeconomy was incomplete. Did Ireland get a bad deal from Europe?

Chairman: Sorry, you can ask Mr. Buti about the deal and his value-----

Senator Marc MacSharry: I am sure the people would be interested. He might like to

answer it. Can we see if he would like to answer?

Chairman: Yes, he would. If he can be asked a question that is not a leading question I am sure-----

Senator Marc MacSharry: That was not a leading question; I am quoting testimony. With respect, I am quoting testimony from three other witnesses, one of whom is this man's predecessor.

Chairman: You then tried-----

Senator Marc MacSharry: I am sure the people are interested in that answer. Would Mr. Buti like to answer that question?

Chairman: Mr. Buti, could you relay through the Chair, please? You can quote as many people as you like, Senator, but the-----

Senator Marc MacSharry: It is you who is trying to lead the witness. You are telling him not to answer a question. He may well like to answer that question and I think it would be in the public interest if he did, frankly.

Chairman: Senator, I am going to-----

Senator Marc MacSharry: I understood we could quote from testimony from previous people. That is what I have done. The level of prescription in terms of actions and questioning in this inquiry so far is not acceptable and I have to say that if you persist in this, we are going to have discussions outside the room about the process in the future. I have asked a question and I want to see if Mr. Buti wants to answer it without you telling him not to answer it.

Chairman: I will give you plenty of time, Senator. We do have discussions with regard to the preparation for lead questioners every time. The matters you have talked about were not raised at the discussions.

Senator Marc MacSharry: That is neither here nor there. I do not need my questions approved by the Chair.

Chairman: No, but what you do need is to operate with the legal framework-----

Senator Marc MacSharry: I am. As far as I am concerned I am operating precisely within the legal framework.

Chairman: The legal opinion comes from the Chair and is advised, and is also worked out at lead questioner sessions. Mr. Buti, in regard to the quotations Senator MacSharry used, which have been presented before the inquiry, the question with regard to the bailout is something you may have an opinion upon with regard to the deal we got and we ask you to share that with the inquiry.

Senator Marc MacSharry: I did not specifically say the bailout. If you want, I will rephrase the question or repeat the question as asked. Did Ireland get a bad deal from Europe? I quoted three testimonies. One was from Mr. Buti's predecessor, another was from Professor Bill Black and a third was from Professor Ed Kane. I do not need to repeat them I am sure. I am interested to know if Mr. Buti feels Ireland got a bad deal from Europe. Of course he does not have to answer the question, as the Chairman rightly said, but the Irish people might have

an interest in someone of his seniority within the European Commission and his view on it.

Mr. Marco Buti: I understood that this is about the pre-crisis period. I do not want to sound reticent. I have my opinion on this having lived through that period. I understand there is a nexus phase of the inquiry where the whole response to the crisis will be addressed.

Ireland had extraordinary growth before the crisis. There was a healthy period and a less healthy period. We focused at the time, with the economic paradigm we had in mind and with the tools we had, on something which turned out to be incomplete at best. Ireland had an extremely rough time when the crisis erupted and Europe had to step in to help and rescue the Irish economy.

I agree that there was an existential risk posed by the sovereign debt crisis from countries like Ireland, but also Greece, Portugal and, to a certain extent, Spain. We were seeing at the time the risk of collapse in the euro. The committee members may all remember the *Financial Times* website was counting the minutes of the life evolution of the euro crisis as if we were just about to collapse at any moment. Ireland was part of this. Overall, assistance was deployed. We were fixing the plane while flying because we did not have the tools and the firewalls to address the crisis at the time. Crisis prevention has been strengthened since then. The tools to deal with the crisis have been put in place. That is where we stand.

Ireland has exited the assistance programme. We have forecast a return to strong growth in 2014 and 2015. Ireland is back on its feet at this moment in time.

Senator Susan O'Keeffe: I thank Mr. Buti. I would like to start with what he says on page 8, where he says: "We assumed they would do their job in a conscientious manner." He was, of course, speaking about national supervisors and regulators in regard to their supervision of the banking sector. Did the regulators and supervisors in Ireland do the job in a conscientious manner?

Mr. Marco Buti: I have seen the testimonies of a number of guests before me. The current Governor of the Central Bank, Professor Philip Lane and others have indicated that the focus of supervision and the responsibilities carried out at the national level were incomplete at best. The focus was essentially on a bank-by-bank state of health. The State did not consider the stability of the financial sector as a whole. The supervisors were not paying sufficient attention to these matters and the fiscal policy at the time was also an issue. I am not talking so much about the fiscal stance in macro-economic terms but rather in terms of the composition of fiscal measures, including the type of tax measures which were taken, which helped to fuel the property boom at the time. In retrospect, there were failures on the supervisory front and in fiscal policy. Previous testimonies have been clear, and I agree, that especially when one enters an economic and monetary union in which monetary policy, interest rate and exchange rate tools are no longer available for national purposes, one has to be overly cautious and extremely attentive to fiscal policy and supervisory practices. At the time, in Ireland, but not only Ireland, there was not sufficient attention on these tools.

Senator Susan O'Keeffe: Was it a good approach on the part of the Commission to assume that anyone would do their job in that manner?

Mr. Marco Buti: If asked now, I would say "No". If asked at the time, our view - I tried to state this in my initial address - was that we had this so-called great moderation in mind, which was incomplete if not faulty. We followed that type of, let us say, parody and we had the tools

which were commensurate to that type of parody. This was the assumption at the time. Now I would say it was a mistake. We did not have the tools. Unfortunately, we were together with many others. The line-up of guests which has preceded me has indicated that they were in a sense clouded by the same type of views.

Senator Susan O'Keeffe: Mr. Buti states on page 8 of his presentation that the Government - meaning the Irish Government - had to step in with its deep pockets to stave off the collapse of the financial sector and the economy as a whole. Will Mr. Buti explain what he means when he states the Government "had to" step in?

Mr. Marco Buti: When the crisis erupted, clearly a collapse of the banking system, which would bring down the whole financial system and the Irish economy, was an issue. Intervention by the Government was needed at the time in order to prevent such a collapse. We know this would have been catastrophic for the banks and the whole Irish economy, with an important contagion effect on the rest of the euro area. This does not mean that the intervention of the Government was perfect. It has been remarked that the blanket guarantee which was issued in 2008 was not a good idea. We were not notified of it. We knew it *ex post*. In retrospect, this was an excessive coverage of the banks.

Senator Susan O'Keeffe: The expression "had to" does not mean the Government was forced to do this.

Mr. Marco Buti: To my knowledge, not by the European Commission.

Senator Susan O'Keeffe: In January 2001, the EU Commissioner, Pedro Solbes, announced a recommendation under Article 99.4 of the treaty would be made against Ireland. I understand this was the first time a recommendation of that kind had been made. How important or significant was it or was it run of the mill? Was it a case of, "We can do this. We will start here"? Was it a very big, important moment?

Mr. Marco Buti: I joined the Commission in 1987. I was not directly in charge of these matters at the time. However, we had an important debate within the directorate-general at that time. Ireland was growing strongly. There was the Celtic tiger. There was a draft budget which was procyclical, meaning it was adding oil to the fire. At the same time, there were several other countries in much poorer condition.

In my opening address, I indicated the growth in Ireland and the growth in the rest of the euro area, where there was much higher debt and higher deficits. The issue was whether we should come out pinpointing Ireland, which was the poster child of Europe, with a recommendation. There was a genuine discussion on whether we would be getting it right by doing so. In retrospect, what was done was right. While group think, also called the great moderation paradigm, affected most observers at the time, the recommendation strayed outside this common view.

The Commission was deeply criticised at the time. In Ireland, it was very badly received. The Senator may remember the huge controversy. Europe was pinpointing Ireland when it was doing so well. Why does it not look elsewhere? Not only some but many academics criticised the Commission saying, "You are just looking at decimals. You are bureaucrats." In retrospect, it was the right approach. In a sense, this recommendation was the embryo of what we have done later on in terms of focusing on having the right fiscal stance for Ireland and other countries. In a boom period, fiscal policy has to be very cautious and restrained in order not to be

behave in a procyclical way. It was, therefore, an important moment.

Senator Susan O'Keeffe: Mr. Buti makes clear on page 5 of his statement that it was not implemented by Ireland. Who in Ireland did not implement it?

Mr. Marco Buti: The Commission recommends or proposes and the Council adopts. The Commission recommended it, the Council adopted it and the recommendation was addressed to the Government of Ireland. The Government of Ireland did not implement the recommendation.

Senator Susan O'Keeffe: As Ireland did not implement it, was this something of which the European Commission took cognisance or remembered? How would it have fed into our relationship with the Commission over the years which followed, given that the Government had not implemented what it was asked to implement in 2001, or was it just a case of it not mattering?

Mr. Marco Buti: At the time we did not have the possibility, institutionally and legally, to follow up when a recommendation was not implemented.

Senator Susan O'Keeffe: I understand that, but I am asking whether this fed into or changed the relationship between Ireland and the Commission or did it make any difference?

Mr. Marco Buti: No, that I would not say. We continued to follow and monitor the Irish economy and the Irish policy making as we have done with other countries. Certainly the fact that this recommendation was not taken seriously was, in retrospect, a mistake. It was a mistake because there was no recognition that fiscal policy could play a more stabilising role. It was not so much the recommendation in each implementation at that particular moment. It was, in a sense, the example of a type of reasoning which would say "We are doing so well, we are in surplus and don't bother us."

Senator Susan O'Keeffe: I wish to clarify. At that time and in those conversations, was all that done in writing only? Were there face-to-face meetings with the Minister for Finance, the Taoiseach or the Tánaiste? Was it just a mindset of here is the piece of paper and get on with the job?

Mr. Marco Buti: No. The way it works is the same now. The Commission issues a recommendation. It is discussed in committees with government officials where there is a discussion on its merit as well as its wording. This leads to the adoption by the Council. There was a discussion by the ECOFIN Council which was attended by all the Ministers, such as Commissioner Solbes at the time as well as the Irish Minister for Finance and eventually the Council adopted the recommendation. There is a mix of formal proceedings, written recommendation and discussion in the appropriate institutional fora.

Senator Susan O'Keeffe: Mr. Buti said on page 6 that as the years passed, and we are talking about 2002 to 2006, inclusive, "the Commission did not shy away from taking a critical view" of Ireland. Mr. Rob Wright gave evidence here following his report on the Department of Finance. He said Mr. Buti's criticisms "were leavened by favourable comment and even praise for Irish policy." How could Mr. Buti be critical and praising at the same time? Was that not a mixed message? How could anybody know what he was saying? Does Mr. Buti believe he did not shy away from taking a critical view?

Mr. Marco Buti: As always, when we address economic policy-making of a country, one

has critical views as well as more positive views. At the time Ireland grew very strongly. There was overall, according to the great moderation paradigm, relatively reasonably low inflation, there was very strong growth and the budget was either balanced or in surplus. We think considering the constraints and the framework that we had at the time, Ireland performed very well. We had to go beyond that in order to highlight the risks. There was always, as it is now, a mixture of acknowledgement or surprise, as indicated, as well as critical remarks. I would not say it was a blurred message. It was a more nuanced one where the elements of criticism and risks, in particular, related to the impact of the housing and property boom and the kind of implication this had for fiscal policy in particular. We saw the increase in revenue as being potentially transient. Indeed, when the crisis hit this revenue disappeared and then the emperor was naked.

Senator Susan O'Keeffe: On page 8, Mr. Buti says that the Commission's stability programme updates did not review developments in the banking sector between 2001 and 2007. I appreciate that situation may have changed now. However, the public would scratch their heads and wonder how could any economic commentary or assessment of a country, in that format, possibly exclude its banks. How could that have been?

Mr. Marco Buti: I agree with the Senator. If we look at it now it seems incomplete which is a kind word for it. Now we know much better what the situation is, how the economy works and the role of the banking and financial sector in this. Now we see that there are risks, potentially, concealed in the working of the financial sector in the banking system which may amplify booms leading to bubbles or creating shocks or misallocating resources and capital by conveying them to the property market.

Senator Susan O'Keeffe: Mr. Buti's organisation did not know that then.

Mr. Marco Buti: At the time we did not have that kind of focus. The focus was on macroeconomic variables, inflation and the budget which was the main point. It is not that the banks and financial system was disregarded but it was not part of this macro-economic surveillance because the focus on the banking side was more, as I said, on micro prudential. It was bank by bank. We did not see, at the time, the risks for the system as a whole and the spillovers on the macroeconomic stability of the country. Now we know better.

Deputy John Paul Phelan: I welcome Mr. Buti. I shall commence by asking a couple of general questions.

When one is a member of a committee like this one finds oneself reading all sorts of documents. I found myself reading the mission statement of a Directorate-General of the European Commission. It reads:

> The mission of the Directorate-General for Economic and Financial Affairs is to contribute to raising the economic welfare of the citizens in the European Union and beyond, notably by developing and promoting policies that ensure sustainable economic growth, a high level of employment, stable public finances and financial stability.

In the period before the banking collapse, was any of that achieved or not?

Mr. Marco Buti: Almost all of the first order indicators were met - a high level of employment, strong growth and relative macroeconomic and monetary stability. The financial system did not show up, as I indicated before, as any particular disequilibria at the time. There was strong potential growth also. it is not because I do not want to say this was due to the European Commission or my DG but, *prima facie*, almost all those elements, to different degrees, were

met.

If one scratches the surface and goes beyond that, then we see that the kind of growth model that we had at the time, not in Europe in general but in a number of countries, we can see Ireland's was, first and foremost, based on elements of non-sustainability which came to the fore when the crisis erupted.

Deputy John Paul Phelan: I wish to ask a question on that matter specifically. Does Mr. Buti think that the European Commission's surveillance responsibility has been a success? With specific reference to Ireland in the lead-up period to the collapse which we have been discussing, does he believe the Commission was successful or not? I cannot ask a leading question.

Mr. Marco Buti: From what I have indicated before throughout my testimony, it was successful considering the kind of predicament we had at the time or the kind of remit and institutional responsibilities that we had at the time. We signalled a number of underlying disequilibria which were brewing in the system. We underlined a number of risks. We could not pursue it fully because we had limitations in terms of the tools for monitoring that we had at the time. Unfortunately, and most important of all, we had no enforcement power for going beyond first-order developments.

This is what we did at the time. In retrospect, one can certainly see that had we had a more correct or more complete view of the behaviour of the economy, and if we had had what was put in place later on - that is, a more complete set of tools, including enforcement tools - then we would definitely have done a better job.

Deputy John Paul Phelan: Much of your statement referred to the Stability and Growth Pact. In 2003 France and Germany were the first two countries to break the 3% deficit limit that was part of the pact. As you said, Ireland never breached that 3% limit, at least during the Celtic Tiger years. Is it fair to say, as some commentators have, that the terms of the pact were not fit for purpose - or, to rephrase that, do you think they were fit for purpose or not, in light of the fact that the first breach was by France and Germany and no corrective action was subsequently taken?

Mr. Marco Buti: As you rightly recall, the 2003 crisis was due to a lack of compliance with the Stability and Growth Pact by the two largest members of the euro area. You will recall also the Commission, at the time, took the courageous decision of taking the two countries and the Council to court over that. Subsequently, the pact was reformed to make it more fit for purpose. In the case of Ireland, the way the pact was conceived and implemented at the time did not capture the essence of a country with such exponential growth rates. With the budget artificially improved by high tax elasticities related to the property boom, the parameter of the pact that focused on the 3% deficit limit and the 60% debt limit did not allow for the essence of the Irish problem. We know better now, and the set of tools that we have allow us to focus on problems that are specific to Ireland.

Deputy John Paul Phelan: Just briefly, I have a series of questions, and I will cut it down to one.

Chairman: No. There will not be a series of questions; there will be one short supplementary.

Deputy John Paul Phelan: I was just saying that, Chairman.

The question is about auditors, and I have asked it of many of the witnesses. The European Commission proposed far-reaching reforms to the audit sector before the banking crisis, and these reforms were subsequently changed. Do you believe it should be mandatory for bank auditors to rotate and, if yes, why? Do you believe the mandatory rotation of auditors, as proposed by the Commission in the 2003-2008 period, could have led to higher levels of vigilance in the Irish banking sector?

Mr. Marco Buti: I have to disappoint you, because this is not within my current set of responsibilities. I cannot answer this question. I apologise.

Deputy Eoghan Murphy: In the course of your surveillance of Ireland between 2001 and 2007, did you pay attention to academic articles that were published, work by the ESRI or media articles?

Mr. Marco Buti: In the context of our surveillance, we interact with all actors. We talked to the ESRI, we talked to other academics in Ireland and beyond, and we talked to social partners of the Government. There is, and was, ample interaction with all actors.

Deputy Eoghan Murphy: So the Commission would pay attention to reports by the ESRI - its medium-term reviews and quarterly economic commentaries?

Mr. Marco Buti: As with the other resources, yes.

Deputy Eoghan Murphy: Would the Commission respond to those? For example, the 2005 medium-term review from the ESRI mentioned a lot of problems in the economy that we had talked about in 2001, would the Commission take a view on a report such as that coming from a country?

Mr. Marco Buti: We do not formally respond to articles or projections of this sort, but they enter into our broad assessment inventory. Before we complete each forecast we come on forecast missions and we visit the various actors. I have been in close touch with Professor John FitzGerald, who is a good friend.

Deputy Eoghan Murphy: When you made those visits to Ireland - to speak with John FitzGerald of the ESRI, for example - did such people convey any warnings or serious concerns they had about the economy at the time, in the period from 2005 to 2007?

Mr. Marco Buti: I think John FitzGerald came and gave his testimony here. I largely agree with what he says. I cannot tell you now exactly whether there was such a warning in that particular year. I think there was praise for Ireland's spectacular economic performance on the one hand, together with looming concerns about a number of developments which were taking place, but which did not manifest themselves in such a glaring way as they did afterwards.

Deputy Eoghan Murphy: Were you asked by the ESRI to intervene with the Government in relation to fiscal policy?

Mr. Marco Buti: I cannot tell. Not because I do not want to; I do not know.

Deputy Eoghan Murphy: You do not remember from those meetings?

Mr. Marco Buti: No; I cannot recall. These types of interaction are the normal ones we had with economists and desk officers at the time.

Deputy Eoghan Murphy: When John FitzGerald was before this committee, his recollection was that he did ask the Commission to intervene with the Government, but the Commission took the view that it could not.

Mr. Marco Buti: Yes. I have seen that, and I have to say that I did not recall it myself. I do not have evidence that this happened in any formal manner. If there was some oral communication, I cannot tell you. There was no formal request or communication of this sort. If something like this happened, it must have been in context of normal interactions we have with Irish commentators.

Deputy Eoghan Murphy: When you were in Ireland having discussions with the ESRI and talking about its reports, did your discussions inspire confidence in the opinions it was giving in its quarterly economic commentaries?

Mr. Marco Buti: I cannot substantiate anything of this. The only thing I can tell you is what I have already said: we interact with many actors. In Ireland we collected views and we shared our views. This is the positive interaction we have with Irish observers, commentators and economists, as we do with any other country.

Deputy Eoghan Murphy: And would you interact with the IMF and its staff reports on the country?

Mr. Marco Buti: We always do. The IMF has Article IV report which focus on national economies. They stop by in Brussels before coming, in this case, to Dublin, or we speak afterwards, so we are in close contact. The IMF, as well as other international organisations such as the OECD, shared the same paradigm of great moderation that all of us followed. If you look at the recommendation in their assessment, it is largely convergent with ours.

Deputy Eoghan Murphy: I am looking at the critical opinion from the Council in 2001. It is clear there is a risk to monetary union and that prudent fiscal policy is the means to counter these risks. It is also clear that Ireland was not pursuing prudent fiscal policy in 2001. How is the Council opinion of 2001 not still relevant in 2005, 2006 and 2007, given what the ESRI and the IMF were both saying at the time?

Mr. Marco Buti: It was relevant, in a sense. We highlighted in our assessment the risks related to fiscal prudence. We saw, in particular, that the model of relying increasingly on revenue arising from property taxes and housing taxes, which replaced a more stable form of revenue and financed Government spending, was a model which carried risks and we signalled that. That is what we did at the time. We rang the bell but, again, formerly, with a country in surplus and with a sizeable surplus in certain years, it was very difficult to say it was not behaving according to the Stability and Growth Pact, because it did.

Deputy Eoghan Murphy: It was the Commission's responsibility to say that to the country, despite how it was growing.

Mr. Marco Buti: We said that. We signalled that repeatedly. Did we signal it in a sufficiently strong way considering what we know now? The answer is "No". At the time, we thought it was the type of warning that was needed and, unfortunately, it was only half followed.

Deputy Joe Higgins: On page 4 of Mr. Buti's introduction he refers to an EU Commission policy framework from the pre-crisis period, which is sometimes referred to as the great moderation paradigm. For somebody in the 1960s it would sound like something from Chairman

Mao's *Little Red Book*. In any case, Mr. Buti says there are two aspects to it - low and steady inflation, and prudent and sustainable fiscal policy by government. As long as those were observed, apparently, there would be no major problems. Has Mr. Buti heard of Professor Morgan Kelly, a well known academic in University College Dublin?

Mr. Marco Buti: No.

Deputy Joe Higgins: That is fine. As early as 2006, Professor Kelly referenced housing property bubbles in Finland in the 1970s and in the Netherlands in the 1980s which crashed and caused havoc within those economies, including a banking crisis in Finland. He further referenced studies in a few dozen OECD countries of housing bubbles which had a similar effect over the previous 20 years. How could the EU Commission miss the significance of such a bubble with that type of concrete experience?

Mr. Marco Buti: As I indicated, this was the paradigm at the time. It was shared by the EU institutions, the IMF, the OECD and so forth. The international organisations thought the focus was essentially on fiscal policy and on stable inflation. It does not mean that there were not others who looked at different matters. We looked at the house prices. We were not ignorant of this. I do not know these particular studies, but the idea was that we had a model of development. We had the Celtic tiger which was very much export-led in the 1990s. We had a convergence of prices, both the general consumer price index as well as housing prices, towards a higher level commensurate to the increase in income. The issue at the time was whether the property and house prices were an equilibrium phenomenon or a bubble.

In retrospect, we know that at a certain point in the mid-2000s the situation got out of hand and house prices clearly grew exponentially. However, at the time there were a number of analyses and commentators that considered the increase in house prices as part of this adjustment of the Irish economy and an equilibrium phenomenon. The hope at the time was that one could deflate the house price boom gently and have a soft landing. Prudent fiscal policy, sound monetary policy and low inflation were considered to be sufficient to deflate the bubble, together with appropriate supervisory practices. This was the model at the time.

Deputy Joe Higgins: I understand. At the same time, however, the credit extended by Irish banks was going through the roof and was being financed by massive loans from European banks. A witness from the United States, Professor Black, said that when banks are growing by approximately 20% year-on-year, all kinds of red lights should start flashing that the loans are not sustainable. How could the EU Commission miss that indicator as well in the bubble or pre-crisis period?

Mr. Marco Buti: I risk repeating myself. We did not have the type of tools that we have now.

Deputy Joe Higgins: I accept that it did not have the tools. However, how could it not have the knowledge and recognition that this was a disaster in the making, given all the resources it has and the lessons of history?

Mr. Marco Buti: The growth model of the Irish economy transformed itself from an export-led economy to more domestic-led growth. This went hand-in-hand with a development, considering the domestic sources, of the housing market which was considered to be a healthy one. The focus then, as I indicated, was on other matters. We signalled that there was an issue related to this, but we had neither the tools nor, I am the first to admit, the type of focus on

developments in the housing market, the financial markets and the banking sector which could have prevented that. With the benefit of hindsight we should have done that, but the focus at the time was in line with the great moderation paradigm and this was what we did, as unfortunately did many others who have been witnesses before me.

Deputy Joe Higgins: Unfortunately, we are caught for time. Mr. Buti said it was considered that the Irish housing market was a healthy market. However, in a briefing document from our researchers we read that in a number of years during the housing boom the increase in the value of the average home was larger than the amount of money a worker on the average industrial wage would take home over the full year. The research further found that over a ten-year period, from 1996 to 2006, the price of an average home for a working person increased by the equivalent of the average industrial wage each year for ten years. It states that the increase in house prices created significant opportunities for investors to make large profits in housing development. Does that look like a health housing market situation when young working people are the subject of such profiteering? Was that not seen by the EU Commission during that period as well because it was flagged here in Ireland?

Mr. Marco Buti: In my initial address, I indicated that the increase in house prices got completely out of hand. What I was simply saying is that the Celtic tiger period was followed by a period of growth which was more domestically oriented. In the initial phase, this switch of the model, from export growth to domestic-based growth, went hand in hand with an increase in the importance of the housing market. I fully agree with Deputy Higgins. Then the system and the market got out of hand and, clearly, there was - what, in retrospect, is clearly - a bubble, and a very unhealthy one. I do not at all say that we considered the developments in the housing market in Ireland a healthy one. I said at the beginning it was normal that there was this switch from export-led growth to domestic-led growth and we can see now in retrospect - we signalled at the time, though not in as forceful a way as one could have done - that there were a number of elements in the supervisory practices and in the conduct of tax policy and fiscal policy in general and taxation in particular, which added fuel to the fire. This is the assessment that we have now. At the time, if one looks at all the technical assessments of the stability programme of Ireland issued post 2001, regularly one finds these type of warnings, but it is true that we did not fully draw the consequences of this and ring the bell as loud as one could have done had we had the knowledge and tools that we have now.

Deputy Kieran O'Donnell: On page 5 of his testimony, about the 2001 recommendation where the Commission had difficulties with the spending in the economy, Mr. Buti states: "As some of you may remember, the recommendation was not very well received in Ireland; it was not implemented." I have two questions. Who, specifically, is Mr. Buti talking about in stating that it was not well received in Ireland and what precisely were the recommendations?

Mr. Marco Buti: I am not here to name names. This is the rule in the committee.

It is clear that there was a storm of criticism in Ireland in general about the Commission finger-pointing Ireland for misbehaviour. There was clearly very strong criticism of the Commission focusing on a particularly critical issue while Ireland was doing so well. As I indicated before, this criticism was not only from Ireland, but also from academics outside Ireland.

Deputy Kieran O'Donnell: Did Mr. Buti receive criticism from Government and Departments in Ireland?

Mr. Marco Buti: The criticism was quite general at the time and the recommendation was

not implemented.

Deputy Kieran O'Donnell: Specifically, did the Commission receive direct communication from Government and the Department of Finance criticising this recommendation?

Mr. Marco Buti: When we issue recommendations, we do not come out of the blue and just publish in the Official Journal a piece of paper. When the Commission issues a recommendation, we have discussions in the committee where the Irish officials are present and they make legitimately their point, as do all the other member states. Then there is discussion in the Council where Government is present at the level of Ministers, and from the Commissioner viewpoint, there was Mr. Solbes, who was then the Commissioner in charge. This is the process through which a recommendation is issued. There is a recommendation and the Council adopts it, and in all this process there are discussions which are informal or formal in each of the fora.

Deputy Kieran O'Donnell: From the Irish Government at the time, there was criticism of the recommendation. What were the recommendations? Would Mr. Buti state specifically what were the recommendations?

Mr. Marco Buti: I can read the recommendation.

Deputy Kieran O'Donnell: In the limited time, I do not need it in detail.

Mr. Marco Buti: On the recommendation, the Council of the member states, six months before, had issued what was called broad economic policy guidelines, which was the only tool that we had outside the Stability and Growth Pact at the time. What was said at the time was a call, in the broad economic policy guidelines, on Ireland to have a fiscal policy which would exert a restraint in order not to be, as they say of economies, pro-cyclical or add to the boom. This was the broad economic policy guideline. Then there was the draft budget 2001 presented by the Irish Government. Subsequent to that, the Commission recommended removing the inconsistency with the broad economic policy guidelines by the budget plan in 2001 by taking countervailing budgetary measures during the current fiscal year. The issue was to temper with restraining measures the expansionary effect of the budget, which was clearly pro-cyclical.

Deputy Kieran O'Donnell: I thank Mr. Buti. I will follow on from that. The Commission completely changed the direction in the 2002 recommendation. I have a question on the backdrop there. Mr. Buti mentioned in his presentation that the Commission found mortgage interest relief on property as a negative and yet in the 2002 budget the then Government reintroduced mortgage interest relief on rental or investment properties for the first time since 1998. The question I am asking is did the criticism from the Irish Government on the 2001 recommendation influence the Commission's decision in terms of the 2002 recommendation?

Mr. Buti also makes reference to this. In his presentation, he states, "In retrospect, the assessment of whether the 2001 Council recommendation to Ireland was a good idea or not is less clear cut; even controversial." It would appear as if the measures that were brought in in 2002 were even more pro-cyclical in terms of mortgage interest relief and yet the Commission did not make the same recommendation.

As an adjunct to that question, Mr. Buti also states in his report-----

Chairman: I must ask the Deputy to finish.

Deputy Kieran O'Donnell: -----that the structural deficit was overstated in retrospect.

In that time period, the Commission was basically saying that the structural fiscal position for Ireland was positive. Looking at it now, what is the Commission's current estimate of the structural balances prior to 2008?

Chairman: The Deputy has it.

Deputy Kieran O'Donnell: That is the question. With due respect to the Chairman, I am trying to work within the confines. I ask the Chairman to give me some latitude.

Chairman: I have given Deputy O'Donnell loads of latitude because he is over time already.

Deputy Kieran O'Donnell: I appreciate that.

Chairman: I ask Mr. Buti to respond.

Deputy Kieran O'Donnell: With due respect, I am operating within the time constraints.

Mr. Marco Buti: Deputy O'Donnell's question is a complex one. It encompasses different aspects.

Deputy Kieran O'Donnell: It is an important one.

Mr. Marco Buti: Let me try to address them. First, what changed between 2001 and 2002? The main element that changed was that the ICT bubble struck the global economy. So there was a very rapid downturn in the global and European economies. In the case of Ireland, much of the healthy growth which occurred during the Celtic tiger period was based on ICT and high-innovation products and this was the reason for its wealth. There was a collapse in growth between 2001 and 2002. The kind of criticism that was directed towards the budget prior to the unexpected collapse in the ICT economy seemed less appropriate *ex post facto* because the economy had, in a sense, collapsed on its own. That is why in 2002 we did not repeat the criticism we offered in 2001.

The second point is that unlike the position now, the degree of generality relating to the recommendations was quite high during the period in question. We basically said that countervailing measures should be taken. However, we did not stipulate which measures should be taken. The issue of subsidiarity is important and our recommendations remained at quite a high level of generality. The issue on which we place a great deal of emphasis now, namely, the quality and composition of public finances, on both the spending and revenue sides, were not the focus of attention at that time to which I refer. We did not, therefore, go into the kind of specifics to which the Deputy referred.

On the Deputy's final point, estimating the structural surplus is particularly difficult. We know it is an unobservable variable. In retrospect, Ireland's budgetary position at the time was less solid than we believed. This was the case for two reasons. First, at the beginning of the last decade we were, like many others, anticipating the growth of the Irish economy to remain high during the following few years. The potential rate of growth was, therefore, considered to be very high. Second, at the time there was what economists refer to as very high tax elasticity. The budget was improving as a result of high tax revenue but, essentially, this was linked to the property and housing market. In retrospect, with more normal elasticity and a sustainable growth rate that was not artificially fuelled by activity in the property market, things would have been different. However, budgetary conditions at the time were less healthy than we thought.

Chairman: I thank Mr. Buti. I remind members that they need to ensure that they accommodate Mr. Buti and other witnesses in the context of allowing them to answer within the time allocated. If this does not happen, we will continue to run over time. People back-loading a number of queries into their final question will not facilitate witnesses in answering.

Deputy Pearse Doherty: On Mr. Buti's final point regarding Ireland's structural balance, is the Commission of the view that its forecasts up to 2007 were correct or incorrect?

Mr. Marco Buti: I have just answered that in reply to Deputy O'Donnell.

Deputy Pearse Doherty: I am just asking whether the Commission's assessments were correct or incorrect in the lead-up to 2007.

Mr. Marco Buti: In the context of what we could estimate at the time, we used the best the analytical tools and technology available. I recall that the analytical tools to estimate potential structural deficit were not-----

Deputy Pearse Doherty: With respect, I intend to ask a follow-on question in respect of this matter. I just want Mr. Buti to indicate whether the assessments were right or wrong in the lead-up to 2007.

Mr. Marco Buti: At the time we used the best tools available and we thought they were right. In retrospect, the structural balance was less healthy than we estimated. If the Deputy wants a direct answer, then they were wrong.

Deputy Pearse Doherty: They were wrong. That is fine. In reply to Deputy O'Donnell's question on why they were wrong, Mr. Buti referred to tax elasticity and the high levels of tax that were being collected from property-related sectors in particular. Surely the entire notion of a structural balance is not to rely on such elasticity or on increases in tax revenue resulting from a housing boom. How could the Commission factor in increases in tax revenues from the housing market - which it had previously stated was out of hand - in calculating the structural balance, when the whole purpose of the latter is not to include those increases?

Mr. Marco Buti: The Deputy makes a good point. We used the methodology that was adopted by the Council and that was endorsed by all the member states. We have a dedicated group - the output gaps working group - which deals with all of these matters. We realised there was a danger in treating as structural, revenues which had the potential to be temporary. In 2006 we proposed that the output gaps working group focus on this and address the soundness of the methodology used to estimate the structural balance. We brought in the OECD to reassess the position regarding tax elasticity and eventually, in 2007 and 2008, the methodologies were changed. However, that was after the collapse. We were not ignorant of that matter and we had already started the work relating to it. We do not want methodologies to be imposed by the Commission on the member states on a take-it-or-leave-it basis, we want to use analytical tools which are commonly shared among and supported by all member states. This implies that there was a need to come to an agreement and adopt a common methodology. This was done within the working group to which I refer. The proposal of 2006 came into effect only later on.

Deputy Pearse Doherty: When the Commission outlined its views on Ireland's economy - Mr. Buti referred to 2006 in this regard - in 2005 it described the potential output gap as being between 5% and 6%. Despite what has been provided to the members of the inquiry by the investigation team, all of the patterns show that this could not possibly be the case or that there was at least a risk involved. For example, demographics was an issue in the context of labour

force participation and there was a tailing off during the period in question. Is it the case that the Commission was given these estimates and that it knew them to be based on a flawed set of calculations? In light of Mr. Buti's assertion that in 2006 the OECD was asked to examine how the calculations were carried out, is the opposite the case?

Mr. Marco Buti: We used the best tools available at the time. When one assesses the potential growth of the economy, which is necessary to compute the so-called output gap, one must consider the capital endowment of the economy, the position regarding labour force development, demographic issues and productivity levels. To be fair, it is very difficult to assess what is the potential growth rate for a country such as Ireland. It is much easier to assess large, more stable economies than it is to examine the position of small, very open economies which are subject to large external shocks. In objective terms, it was very difficult to do the job in question. This is not to excuse the fact that, in retrospect, we can see Ireland's growth model was unsustainable.

Deputy Pearse Doherty: To try to pin down what happened before the property bubble, Mr. Buti mentioned the market got out of hand and also stated that, in retrospect, it was a bubble. Given everything other members have put forward in their questioning on the rise in house prices, the concentration of lending and everything that happened in the economy in the lead up to 2007, was the Commission at any time of the view there was a bubble in the Irish economy? If so, did it outline this to the authorities? If so, how did it do so?

Mr. Marco Buti: One can look through the many documents produced at the time assessing the state of the Irish economy and Irish policy. It is very difficult to identify whether a bubble exists or whether there is a strong increase in prices which could be part of a phenomenon with more equilibrium. One never calls a bubble *ex ante*. If one looks at assessment by the economic profession in general, objectively the identification of a bubble is very difficult. We had suspicions that certain elements were not part of a natural development of the economy, and in our documents we signalled that a number of measures were adding to these developments.

Deputy Pearse Doherty: With respect, in answer to the questions of other members, Mr. Buti said the market got out of hand, but he went on to say that, in retrospect, it was a bubble. He has given evidence to the inquiry that, in retrospect, the Commission is of the view there was a bubble. My question is very simple and straightforward. At any time during the period up until the bubble burst was the Commission of the view which it holds now, that there was a bubble?

Mr. Marco Buti: We saw a dangerous ongoing phenomenon and we signalled this in our documents. We did not, at the time, draw conclusions on all of its consequences.

Deputy Michael McGrath: I welcome Mr. Buti. This is an inquiry into the banking crisis which cost the State approximately €64 billion. When the European Commission examined Ireland's stability programme update reports from 2001 to 2007, it made no reference whatsoever to our banking sector and the risks being built up within it. Will Mr. Buti explain why this is the case?

Mr. Marco Buti: I have already answered this in my initial statement, and in answer to questions from Deputy McGrath's colleagues. We did not specifically pinpoint the problems in the Irish banking sector. This was part of how the economic profession in general and international organisations and institutions looked at the developments in the economy. At the time we thought that focusing on prudent fiscal policy and price stability would be enough to ensure the

economy grew healthily. There was no focus on the banking sector and I admit this.

Deputy Michael McGrath: Is it the case the Commission did not see the risks in the Irish banking system which were being built up in the pre-crisis years?

Mr. Marco Buti: We saw the risk related to the housing market and signalled this in a number of documents, which are all available on our website. We did not draw conclusions on the policy consequences, which we now know were necessary at the time.

Deputy Michael McGrath: The Commission did not see the risk in the banks building up large losses on their balance sheets because of their dependence on property-related lending. The Commission did not see this risk and its possible impact on the financial stability of the State.

Mr. Marco Buti: As I indicated, one must be careful about pinpointing where responsibility lies. I am not here to take responsibility, I am here as a witness before the committee. At the time, as far as the banks were concerned, the focus was on a bank-by-bank basis and responsibility for this lay with national supervisors. The Commission did not have this responsibility; supervising the banks was not then, nor is it now, part of its institutional remit.

Deputy Michael McGrath: Equally, is it the case there was nothing preventing the European Commission from raising concerns in its annual assessments of Ireland's stability programme update concerning the banking sector and the risks inherent in it? There was nothing preventing the Commission from doing so, was there?

Mr. Marco Buti: There was nothing to prevent the Commission from doing so. We put the emphasis on what we thought was part of our institutional remit at the time, which was the development of the housing market. As I indicated, there was no focus on the banking sector.

Deputy Michael McGrath: I understand. The tools available to the European Commission during the pre-crisis years were an early warning mechanism and formal policy advice. Was the criticism of Ireland in 2001 an early warning?

Mr. Marco Buti: It was a *de facto* early warning, yes. It was not called that formally; it was a recommendation to Ireland under broad economic policy guidelines.

Deputy Michael McGrath: There were no subsequent early warnings pertaining to Ireland before the crisis struck?

Mr. Marco Buti: No.

Deputy Michael McGrath: Was there any formal policy advice from the European Commission to Ireland?

Mr. Marco Buti: There was formal policy advice, because every year as part of our assessment of the stability programme, we issue a recommendation for a Council opinion. This is whereby the Council adopts our policy recommendation. Every year there have been opinions on Irish policy making.

Deputy Michael McGrath: Mr. Buti has made a number of points about the risks highlighted by the European Commission over a number of years. Some emphasis must also be placed on the positive comments it made. For example, its assessment of the 2005 to 2007 stability programme report was that the fiscal position could be considered as sound and the

budgetary strategy provided a good example of fiscal policies conducted in compliance with the pact. A similar verdict was made with regard to the 2006 to 2009 period. Going back to 2005 to 2007, the Commission highlighted downside risks on the macro-economic side, but judged the overall risks to the budgetary projections contained seemed to be on the positive side, particularly in 2006. Does Mr. Buti accept the European Commission did not ring the alarm bells sufficiently strongly enough, clearly enough or persistently enough about any concerns it had about the direction of policy in Ireland?

Mr. Marco Buti: What Deputy McGrath has said is correct. We used the tools we had at the time to ring the bell. It was specifically the responsibility of the Directorate-General for Economic and Financial Affairs to check that what was happening in Ireland with regard policy-making was consistent with the rules of the Stability and Growth Pact. The answer is what Deputy McGrath has said, which is that it was. We had to judge whether the fiscal policy of each country was in line with the Stability and Growth Pact. Ireland was in line with it. What we now know is this was not enough to ensure the healthy development of the economy.

Deputy Michael McGrath: Mr. Buti raised the issue of the Government's response to the crisis and the intervention to prevent the collapse of the banks. He referred to what would have been catastrophic consequences for the banks and the Irish economy, and went on to criticise the broad nature of the guarantee. What, in his view, given the criticism he has made, would have been an appropriate intervention by the Government at the time, given the crisis it faced? What should it have done?

Mr. Marco Buti: I am not in the position to answer this question in a complete manner. What we saw at the time was a move which was not notified to the Commission. We knew it *ex post* and I think there was broad agreement that this was not the best policy that one could have made at the time. In terms of what to do otherwise, I do not want to comment at this stage.

Chairman: I thank Mr. Buti.

Senator Sean D. Barrett: Following on from Deputy Michael McGrath's question, Mr. Buti said the guarantee was too broad. What would he have taken out of the guarantee?

Mr. Marco Buti: While I do not want to comment in detail on this issue, the guarantee was a blanket one and this was understandable in terms of the pressure the Government was under at the time - pressure from the events - and clearly it was a situation which was very dangerous. At the same time this provided a coverage that was simply too broad.

Senator Sean D. Barrett: What would Mr. Buti take out?

Mr. Marco Buti: I cannot say at this stage.

Senator Sean D. Barrett: At the end of page 2 and page 3 of his presentation, for which I thank him, Mr. Buti said the Irish banking sector was severely oversized relative to the size of the local economy and the fiscal capacity of the Irish sovereign. By how much was it oversized and what is an optimum share of GDP to have in banking?

Mr. Marco Buti: It is difficult to tell what the optimal size is. We know the Irish economy at the time was relying very much on the financial sector. This was one of the comparative advantages but we had an oversized banking system which, if I am not mistaken, before the collapse was about 900% of GDP. I think it is being reduced now to about 600% of GDP. I cannot tell whether this is adequate now but before it clearly was excessive.

Senator Sean D. Barrett: On page 3 of his presentation, Mr. Buti said that many states were exclusively concerned with micro-prudential supervision and insufficient attention was paid to macro-prudential supervision. When every single bank goes broke the micro was not well carried out. On the macro side, did the Commission know that rules such as loan-to-value and loan-to-income disappeared during the period coming up to the crash?

Mr. Marco Buti: The decision not to deploy typical supervisory tools such as the ones the Senator has indicated, lacked attention on the part of the supervisor at the time. I think here it has been well established by previous testimonies. This, as I said, was part of the responsibilities of national supervisory authorities. As the Commission we did not have a remit to cover this. Now at EU level with the establishment of the single supervisory mechanism, within the banking union there is the possibility of taking a broader view and we focus now, with the experience we have, much more on macro-prudential so the systemic risks for the banking system and financial system as a whole, not only on a bank-by-bank approach that we had at the time. This was the responsibility of national supervisors not of the Commission.

Senator Sean D. Barrett: What was the procedure? Did Mr. Buti's people visit the Central Bank or take data from it, or visit banks, to discuss issues such as the emphasis on property and the emphasis on borrowing abroad? Were any of these issues ever discussed as part of the supervision?

Mr. Marco Buti: No. What we did at the time as we always do and as we do for all member states, is that we have a regular mission, in this case, to Dublin. We talk to the authorities, social partners, financial market analysts and so on, so all of these elements were discussed. I have to say - I repeat myself - this is what we heard at the time, that the focus of surveillance was within the Stability and Growth Pact, essentially Ireland's fiscal policy, and on the overall macro-economic developments. It did not focus on the banking sector in the financial system.

Senator Sean D. Barrett: On page 8 of his presentation, Mr. Buti said the sudden drop in residential house prices undermined the viability of most Irish banks and exposed a striking lack of supervisory and regulatory rigour. That writing was on the wall long before that and it did not take the decline in house prices to know that what was going on was not sustainable.

Chairman: I will take a final question from the Senator.

Senator Sean D. Barrett: Mr. Buti said he did not shy away from a critical view of Irish fiscal policy making. Did he shy away from a critical view of Irish monetary policy-making?

Mr. Marco Buti: In regard to monetary policy-making, we looked at the behaviour of inflation. Inflation for most of the period was slightly above the European average but in a country still in a catch up phase, this is normal. In terms of the overall responsibilities for monetary policy, that rests with the ECB and not with the Commission.

Senator Sean D. Barrett: I thank Mr. Buti.

Senator Michael D'Arcy: I thank the Chairman and thank Mr. Buti for appearing before the committee. Mr. Buti said that for the first time Article 99.4 of the treaty was used. What was the sanction for the usage of Article 99.4? Was there a sanction in relation to the Government's policy?

Mr. Marco Buti: On the 2001---

Senator Michael D'Arcy: Yes.

Mr. Marco Buti: Unfortunately there was no sanction and there was no way to enforce this recommendation. Basically, what we had at the time was that the Commission recommended Article 99.4 to conduct a more prudent fiscal policy. The Council would recommend and the Council did recommend and it stopped there. It stopped there because there was no element of sanction of any sort. The idea was that through peer pressure, peer conviction and exposing a number of risks, the national policy makers would take that into account but it stopped there. It was soft co-ordination and the enforcement tools, once the recommendation was not followed, actually did not exist.

Senator Michael D'Arcy: Was that a mistake?

Mr. Marco Buti: It was the incompleteness of the tools to monitor surveillance that we had at the time. Now we are much better equipped. The strengthening of the monitoring system and the co-ordination system have been put in place since the crisis, through the so-called tool box on the banking side and the banking macro balances procedure. We had an incomplete set of tools.

Senator Michael D'Arcy: I thank Mr. Buti. Mr. Buti used the term "incomplete set of tools" on a number of occasions. In previous evidence we found out that the Department of Finance in Ireland, before the guarantee before the crisis, considered passing special resolution legislation. The reason that was not used was because it could create the concern that if the legislation was on the Statute Book, perhaps somebody would require it. What is Mr. Buti's view of special resolution legislation? Should that be on all eurozone statute books, or should it have been on all statute books?

Mr. Marco Buti: I am sorry but I cannot comment on that as it is outside my field of responsibility. I apologise.

Senator Michael D'Arcy: Mr. Buti made the point towards the end of his submission that the "financial sector was thought to simply channel funds in an efficient manner to where the real economy needed them". Is that not a very naïve statement about the financial sector?

Mr. Marco Buti: It is not that the statement is naïve but that it was the naïve view at the time. One may recall that, at the highest level of academia, the so-called efficient market hypothesis for financial markets essentially prevailed. The way we looked at financial markets, or the lack of completeness of financial markets in Europe, was such that it was believed the problem was that it would not allow the allocation risk in an efficient manner. We did not see what happened afterwards, namely, that the financial market would have an element of propagation of shocks that could lead to catastrophic events. That was not the focus of the attention.

Senator Michael D'Arcy: When Mr. Buti's colleague from the Commission, Mr. Nava, was before us, I asked him for his view on the three big rating agencies' performance prior to the crisis. He said it was not his sector, but Mr. Buti's.

Mr. Marco Buti: Rating agencies are his sector, actually. I will give the committee my opinion, however. The rating agencies failed miserably before the crisis. This is a quite well-established conclusion. One may even say that the overreaction by rating agencies during the crisis, when they downgraded sovereigns, may have contributed to the debt of the sovereign debt crisis.

Senator Michael D'Arcy: There are a number of cases against the rating agencies in the United States. Are there cases pending in respect of the big three in the eurozone?

Finally, I would like Mr. Buti's view on the big four audit firms prior to the crisis.

Mr. Marco Buti: I cannot answer those two questions. I gave the Senator my overall view on the performance of rating agencies before the crisis. As I said, it is not within my remit or responsibility, nor is the second element.

Chairman: We will move towards concluding. I invite Senators MacSharry and O'Keeffe to ask their final questions.

Senator Marc MacSharry: I have no further questions.

Senator Susan O'Keeffe: I have just two further questions.

Given that Mr. Buti knew at the time there was no sanction for the recommendation and no follow-up, given that he described the model he was able to use as being flawed and given that there were plenty of difficulties, such as the incomplete toolbox, can he understand why people might say it was the best of free-market thinking, with light-touch regulation, and that this was why the Commission did not have the tools, why the model was not great and why there was no sanction? In a way, was it not the case that as 2001 rolled into 2002, 2003 and 2004, the Commission did not pursue the matter because it was, perhaps, afraid of alarming the markets and causing a fear factor?

Mr. Marco Buti: I think that was the view at the time. I have amply testified before the committee that this view was not complete and we did not capture the essence of the interplay between the housing market, banking system and the fiscal system.

Senator Susan O'Keeffe: Mr. Buti has done so.

Mr. Marco Buti: We highlighted a number of problems. We stayed within the remit we had at the time, which was, admittedly, very narrow. For us, the main point was that we had to issue an opinion on the stability programme of Ireland each year, and we issued this opinion. We highlighted some problems of the sort in question but not the systemic ones. We had a narrow view.

Senator Susan O'Keeffe: I am asking Mr. Buti whether that would be described as free-market thinking. In addition, was he surprised at the response by the Irish Government? Was he actually surprised because he said it was a serious decision in 2001? Was he surprised by the level of push-back from the Irish Government. It described the position as bizarre and said it had no intention of changing its plans?

Mr. Marco Buti: I was not surprised. The Commission took the decision which at the time looked controversial, so it was a courageous decision in 2001. I have said many times in today's testimony that, in retrospect, many things were not right. In retrospect, we did not have a set of tools that was complete. In retrospect, the view on the working of the economy was either non-complete or deficient. On this particular case, which is the 2001 recommendation, it was the right one in retrospect but I was not surprised by the push-back because it went against the wind at the time. Ireland was performing beautifully. The public finances were considered to be healthy, well within the 3% limit under the Maastricht treaty. Why should the Commission come out and criticise the poster child? It was a courageous decision. The push-back was

natural at the time so it was not a surprise but in retrospect, as I indicated, what was done was the right thing to do.

Chairman: I thank Mr. Buti for his participation in the inquiry today and for his very informative and valuable contribution, which has added to our understanding of the factors leading up to the crisis. I wish to put on record once again that Mr. Buti's attendance at this inquiry in his capacity as someone involved with the Commission was voluntary. I thank him for the work and preparation he has put in and also for the assistance given to him by his officials this morning.

Sitting suspended at noon and resumed at 12.20 p.m.

Dr. Donal Donovan

Chairman: Our next item is a discussion with Dr. Donal Donovan. I welcome Dr. Donovan to the meeting for a discussion on issues relating to the international, EU and domestic policy context for the banking crisis in Ireland. He is very welcome to the inquiry. Dr. Donovan holds a BA from Trinity College, Dublin and a PhD from the University of British Columbia. He is a former International Monetary Fund staff member, having worked there for 28 years before retiring as deputy director in 2005. Dr. Donovan is currently adjunct professor at the University of Limerick and a visiting lecturer at Trinity College Dublin. He was a member of the investigation team that produced the report of the Governor of the Central Bank of Ireland to the Minister for Finance on the Irish banking crisis in May 2010. A former member of the Irish Fiscal Advisory Council, Dr. Donovan has published a number of opinion pieces on the IMF-EU bailout in *The Irish Times*. He is co-author of the book *The Fall of the Celtic Tiger: Ireland and the Euro Debt Crisis*.

Before we begin, I advise the witness that by virtue of section 17(2)(*l*) of the Defamation Act 2009, witnesses are protected by absolute privilege in respect of their evidence to the committee. However, if they are directed by the committee to cease giving evidence on a particular matter and they continue to so do, they are entitled thereafter only to a qualified privilege in respect of their evidence. Witnesses are directed that only evidence connected with the subject matter of these proceedings is to be given. The committee is asking witnesses to refrain from discussing named individuals in this phase of the inquiry.

Members are reminded of the long-standing ruling of the Chair to the effect that members should not comment on, criticise or make charges against a person outside the House or an official either by name or in such a way as to make him or her identifiable.

I invite Dr. Donovan to make his opening comments to the inquiry.

Dr. Donal Donovan: First, I thank the Chairman and other members of the committee for the opportunity to appear here today. I am happy to provide them with my thoughts on the role played by the IMF in its relationship with the Irish authorities in the years prior to our economic and financial collapse.

I should mention that my observations are offered in a personal capacity. As members of the committee may know, it is relatively rare for IMF staff to be assigned to work in their own countries. I was not involved in the work on Ireland during my IMF career which spanned almost three decades. My thoughts are based on a detailed evaluation of the extensive docu-