

# HOUSES OF THE OIREACHTAS

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## AN COMHCHOISTE FIOSRÚCHÁIN I DTAOBH NA GÉARCHÉIME BAINCÉI- REACHTA

### JOINT COMMITTEE OF INQUIRY INTO THE BANKING CRISIS

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*Dé Céadaoin, 18 Feabhra 2015*

*Wednesday, 18 February 2015*

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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.

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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-

mentation published by the IMF on Ireland in the build-up to the crisis, viewed in the light of my own experience with the preparation of similar documents for many other countries.

The independent evaluation office of the IMF, which, as its name implies, is an independent outfit and usually staffed by external persons, is currently undertaking an extensive assessment and investigation into the role of the IMF *vis-à-vis* the euro area in the years both prior to the crisis and during the crisis itself, with special focus on the experiences relating to Ireland, Greece and Portugal. Since I have been asked to work on this project, I thought I should mention it in passing.

By way of background, it may be useful to explain briefly some elements of the IMF's surveillance process over its members. Normally a team from the IMF visits each country for a period of about two weeks each year to discuss the economic situation and outlook and to review and assess the authorities' policies. A report is then prepared, called the Article IV consultation report, which is subsequently discussed by the IMF's executive board on which all countries, including Ireland, are represented. The report is prepared by the staff, not under the direction of the executive board. The report, together with a shorter document called the executive board assessment, is then published. This report is not subject to review or approval-clearance by the country authorities prior to issuance, except for checking for factual inaccuracies. Before being published, authorities may request deletion of what is called market sensitive information. However, this aspect is interpreted rather narrowly and would not, for example, cover deletions of IMF views that might be quite critical of a country's policies.

Between 2000 and 2010, with the exception of 2008, an important point which I will come back to later, consultations took place annually with the Irish authorities. In addition, in 2006 as part of the financial sector assessment process, FSAP, a separate specialised report was prepared and published on the state of Ireland's financial sector, and this report was discussed alongside the normal Article IV report.

In assessing all of this material, I believe it is helpful to distinguish between the period 2000 to 2007, that is, before the crisis broke, and the 2008 to 2010 period when the crisis began to emerge in full force and the content of the discussions was substantively very different. As an overall comment on 2000 to 2007 period, I think it is widely accepted, and it would be my personal view, that the IMF's surveillance process failed in Ireland. Although, as I will discuss, some vulnerabilities were noted, the assessments by the IMF staff gave no inkling that a major disaster could be in the making. Adjectives such as "exceptional", "remarkable" and "highly impressive" were used throughout the first seven years of the decade to describe Ireland's overall economic performance.

Such overly positive assessments by the IMF were not confined to the case of Ireland and there is no doubt that the organisation did not see warning signals in many industrial countries in the build-up to the global crisis. However, the extent to which a country's economic and financial situation deteriorated so sharply and dramatically with minimal prior anticipation by the IMF, that is, in the Irish case, was to my knowledge probably unprecedented in the history of IMF surveillance. To help understand why such a major misreading occurred, four key areas covered by the consultation reports for Ireland need consideration: the property market, the financial sector, the budget, and the macroeconomic linkages between these sectors.

First, in the case of the property market, in view of what ultimately transpired, it should be noted that the IMF staff did devote considerable attention to the residential property market. Key indicators, such as the movement in prices relative to rents, the increasing proportion of

buy-to-let investors, the historical evidence from other countries' experiences over long periods, and the distorting role of the fiscal incentive regime applicable to property, were all highlighted repeatedly. The thrust of the staff view was that for most of the 2000 to 2007 period, house prices were somewhat overvalued and a speculative element was increasingly present.

Until around 2007, the Irish authorities did not accept the IMF's assessment, arguing that so-called fundamental factors such as the continued rapid increase in personal incomes given Ireland's high growth prospects, inward migration that would boost housing demand, prospective low and stable interest rates, and prevailing low levels of household debt justified the price surges that had occurred. It appears that, in essence, the IMF staff and Irish officials implicitly agreed to differ over this question. In addition, IMF staff had consistently urged from the beginning of the decade the introduction of a property tax and a reduction in mortgage interest relief to help counter a strong pro-house ownership bias. However, in quite candid exchanges in 2004 and 2006, Irish officials, as quoted in the staff reports, referred to "political, like insurmountable difficulties" associated with taking action on these fronts.

Although the message of likely property overvaluation was cited throughout, the IMF staff did not go so far as to suggest the existence of a possible bubble and did not speculate on the size or timing of a possible drop in prices. However, in 2007, the staff report explicitly endorsed the authorities', that is, the Central Bank of Ireland's, view that a soft landing was the most likely outcome. The CBI's judgment was rightly described later by the Honohan report - I should mention again, as the Chairman did, that I was a member of the Honohan inquiry team - as a "triumph of hope over reality". This cautious stance by the IMF may have been due to several factors, some of which may have operated subconsciously: difficulties in challenging definitively the Irish authorities' fundamentals argument; a fear of being seen to cry wolf too often, since the overvaluation thesis had been raised every year since the start of the decade; and also, perhaps, concerns about adverse market and perhaps public-political reactions.

Finally, a major weakness of the IMF's analysis was the neglect of the commercial property market. This aspect was not really dealt with in the CBI's financial stability reports either. However, it turned out to be a crucial, perhaps the most crucial, element explaining the extent of the banks' later losses. My own jointly authored book on the Irish crisis with Professor Antoine E. Murphy, to which the Chairman kindly referred, pointed out that the surge in lending to developers was actually substantially greater than that to householders, especially when lending by foreign subsidiaries was included, and this latter category of lending was highly significant when, in the end, the bill came to be presented to Irish taxpayers. As an eminent scholar of financial crises, Charles Goodhart, once pointed out, "Banks are international in life, but are national in death". When the bill has to be paid, everything comes home to the country where the bank is located.

The second area is the state of the banks. Analysis of the financial sector always featured in the IMF reports but was given much more intensive attention during the 2006 FSAP update exercise. This involved a team of financial sector specialists undertaking a separate, more in-depth, look at the state of the Irish banks. Somewhat sad to say, their overall assessment was reassuring, if not indeed rosy. While, as with the property market, vulnerabilities were mentioned, the typical message was that the outlook for the financial sector was positive and that banking sector profitability and capitalisation were strong. There was no hint given as to the possible occurrence of a major problem, let alone of the potential for the crisis that eventually unfolded. As Governor Honohan has rightly stressed in his report and elsewhere, this clean bill of health from the IMF came at a particularly inappropriate time as it undermined whatever

concerns might have been voiced internally.

Why did the IMF team get things so badly wrong? There are several explanations. First, the analysis was grounded largely on acceptance of the CBI view favouring the soft landing outcome for house prices. While some stress tests involved larger price falls, the possible rise in non-performing loans, NPLs, was, it appears, capped at 5% of all mortgage loans. Second, the neglect of commercial property lending was a crucial omission. Third, while the increased dependency on wholesale external funding by the banks was noted, no one considered what might be the catastrophic effect of a worldwide drying up of liquidity as actually occurred in 2008. Finally, the IMF team appeared to have had no inkling of the indecisiveness and lack of firm engagement underlying the detailed interaction between the Financial Regulator and key individual institutions, problems that were uncovered only much later by the Honohan inquiry.

These were serious shortcomings to which can be added the general approach at the time that favoured so-called principles-based, what is sometimes called light touch, financial regulation. The IMF, being a creature of its member countries, was undoubtedly heavily influenced by this prevailing philosophy. That said, in my view, it would have been incumbent on the FSAP report, as a minimum, to have posted a health warning and cited more explicitly the limitations that underlay the positive conclusions it presented. The Irish experience suggests that the absence of such warnings can seriously undermine the credibility of the IMF's work.

The third area is the budget. The last major area covered by the consultation reports was the budget. Until 2008, Ireland had been running small overall budget surpluses. However, the IMF staff generally urged that these surpluses be increased somewhat, both to counteract what was thought to be overheating, often described as using contra-cyclical policies, and to build up a reserve against future unknowns. By and large this recommendation fell on deaf ears.

A far more serious shortcoming in my view was the conclusion by the IMF up to and including 2007 that the underlying, that is, cyclically adjusted, fiscal balance, CAB, was in approximate balance throughout 2007. This CAB measure attempts to strip out so called temporary factors, such as higher than average growth or transitory revenue flows, that mask the true underlying fiscal picture. In Ireland's case, the IMF, together with the Department of Finance, went along with a common EU methodology used to calculate the CAB.

The problem was that this methodology assumed that the high output levels reached by Ireland in the first half of the decade of the 2000s, which in turn reflected the massive reliance on the construction sector, were permanent structural features. The same assumption applied to the artificial boost in revenues associated with the property boom. Using more technical phraseology, it was assumed that actual output was close to potential output, but the reality was the other way around. Irish output throughout the latter years of the boom was far above sustainable potential. After all, as was pointed out by very few at the time, there was a limit to how many homes people can actually live in. By 2009, the assumptions underlying the earlier IMF calculation of the CAB were clearly untenable. In a quite dramatic reversal, the 2009 IMF report re-estimated the CAB for earlier years using a quite different methodology. For example, the CAB for 2007 turned out to be a deficit of 8.7% of GDP compared with an originally estimated surplus of 0.7%, a change of more than nine percentage points in GDP for the same year. Seldom has the picture of a country's fiscal health deteriorated so sharply and so quickly. The question can be asked if, starting from 2009, a far more appropriate methodology was used, why this was not done in earlier years or at least presented as a variant of the standard approach that had been uncritically accepted.

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The last area concerns the overall macroeconomic interlinkages. The various IMF reports did point out to some extent the vulnerabilities associated with particular sectors, that is, property, financial and fiscal, but they explore the dynamics of a possible downward self-reinforcing spiral such as eventually ended up happening. At best, some first round effects were considered. While precise quantification of a worst case scenario would have been very difficult, some key elements could have been addressed more explicitly. It is possible that the IMF reports did not go down this route because of the somewhat speculative nature of what was involved. It would likely also have been seen as highly alarmist, and provoked strong negative market and, one assumes, political and media reaction. Nevertheless, that complication could have been dealt with by raising the issues confidentially with the Irish authorities as opposed to including a discussion in the published staff report. However, there is no evidence available indicating that such discussions occurred. There could have been pressures both within the IMF and *vis-à-vis* the Irish authorities to dismiss the possibility of such very negative outcomes. The consensus, reflecting perhaps strong elements of groupthink, was to stay with the soft landing hypothesis and to hope that perhaps, in the end, our luck would hold out.

I will turn briefly to the second period, 2008 to 2010, when, of course, things were quite different. The 2007 report was the last rosy IMF report on Ireland. By the time of the 2009 consultation two years later, the picture had changed dramatically. The property market was in free fall, the budget deficit had exploded, unemployment was soaring and the full extent of the banking disaster was starting to emerge. However, no consultation took place in 2008. Normally, the consultation would have taken place as scheduled, unless the authorities indicated a desire to postpone it. The reasons underlying this hiatus are not in the public domain. The postponement meant that during this critical two-year period, from mid-2007 to mid-2009, there was no formal dialogue between the IMF and the Irish authorities. This must be considered a significant flaw. If IMF surveillance is to be meaningful, there should be at least the opportunity for timely inputs from the IMF at a time when, amidst global financial disarray, many key policy options were being considered on the Irish side.

In particular, there are no indications, at least on the public record, suggesting that the IMF staff provided input on the end of September 2008 bank guarantee, either before this decision was taken or afterwards. The 2009 consultation report described the guarantee but did not offer any views as to its appropriateness or otherwise. It did, however, contain a useful table summarising the key features of guarantees provided by various other countries during the past 30 years. This table is summarised as part of chapter 10 on page 214 of the book Dr. Murphy and I wrote. The chapter deals extensively with the guarantee decision. Perhaps contrary to what is sometimes said, it appears from this table that the coverage of the Irish guarantee was not that radically different from that contained in several other earlier guarantees.

Overall, it seems that around this critical time, the IMF did not provide sufficient timely professional technical advice to the Irish authorities. Whether this was primarily a supply side issue, perhaps because the IMF was busy elsewhere, or reflected demand side factors, because perhaps the authorities preferred not to hold the consultation in 2008, remains an important question to which I do not have the answer.

I thank the Chairman and committee members for their attention. I am, of course, very happy to answer any questions they may have on the foregoing or on any other related aspects covered in our book or elsewhere. I received a list of possible questions that committee members may raise and I am certainly happy to do my best to try to answer them as far as I can.

**Chairman:** Thank you, Dr. Donovan. Before I bring in the lead questioners, he might deal

with two issues. First, he might briefly distinguish the IMF's role from those of other international economic organisations. He might tell us why and by whom the IMF was set up. What is its purpose and who funds it?

**Dr. Donal Donovan:** I will try to be brief because that could be a rather long story.

**Chairman:** Just a summary, Dr. Donovan.

**Dr. Donal Donovan:** The Chairman can ask me further about it if I leave anything out. The IMF was set up in 1945, following the so-called Bretton Woods Conference, to try to avoid, collectively, the bad policies that had occurred in 1930s. By now, nearly all countries in the world are members of it.

The IMF has two main functions. One is to lend money to countries that enter into crisis situations and that require bailouts, which we have seen recently. This function has been around for 50 years. It lent mainly to low-income countries, emerging market economies. Before Iceland in 2010, the IMF had not lent to an industrial country for 30 years. The last one was the UK in 1977, but now it is different.

The second function it has, which is what we are talking about today or what I mentioned in my statement, is that it is supposed to exercise surveillance, that is, discuss, analyse and offer policy recommendations, which may or may not be accepted, to member countries, which are then discussed collectively by the IMF board, as I mentioned.

It is possibly the case that the IMF has been more successful in the first activity, which one could call picking up the pieces, than it has been in the second activity in the area of crisis forewarning and prevention. The record would show over several decades that despite many efforts that has not been terribly successful, and the euro crisis would be a good case in point.

The IMF is funded by all the member countries, and the Chairman asked about this. It is like a credit union. Everyone puts in a certain amount of money and that amount of money is calculated; it is basically related to the size of the country in the world economy. There is a total pool of, say, 100, and everyone's contributions are calculated as a percent in regard to their relative size in the world economy. That determines what money they put in, and it also determines the voting power of countries within the IMF. For example, the US is the largest shareholder. It has about 16% of the votes. It puts in 16 cent on every dollar and it has, more or less, its exact equivalent in having 16% of the votes. I do not have the exact figure for Ireland but it is quite small. It has perhaps 0.2% of the votes and puts in 0.2% of the money. I hope that is helpful.

**Chairman:** I wish to ask about two matters arising from Dr. Donovan's statement. This will probably arise in questions later and I would like to get some clarity around it. In the first paragraph on page 4 of Dr. Donovan's opening statement, he states: "However, in quite candid exchanges in 2004 and 2006, Irish officials referred to "political, likely insurmountable difficulties" associated with taking actions on these fronts." Is he referencing that from direct experience he has had that he could provide as evidence to this committee?

**Dr. Donal Donovan:** Yes. I am very happy to do that. This is a direct quote from the published IMF consultation report. If the Chairman will allow me a moment, I can give the exact reference. That particular quote is from 2004 and I will quote it directly: "the authorities noted the politically, likely insurmountable, difficulties of the removing interest-deductibility of mortgages or introducing taxation on property given the electorate's long history of attachment to, and preference for owning, property." That is on page 20 of the 2004 report. In 2006 -

again this is a published document - the authorities “acknowledged the economic desirability of broadening the tax-base but pointed to popular opposition to increasing property-related taxes”. That on page 13 of the IMF report of 2006.

**Chairman:** In the last paragraph of page 8 of Dr. Donovan’s opening statement he states: “However, no consultation took place in 2008.” In the third line of that paragraph he went on to state: “The reasons underlying this hiatus are not in the public domain.” He further went on to state: “This must be considered a significant flaw.” Is Dr. Donovan coming before the inquiry this morning to put matters in regard to this hiatus into the public domain?

**Dr. Donal Donovan:** No. I would not be in a position to do so because whatever documentation that may exist concerning the reasons for this consultation, at least on the IMF side, is not publicly available, and it would not be possible for me to talk about that. A possible way to learn more about this could be to raise the issue with the Irish authorities side who may recall what happened.

**Chairman:** Thank you. The first questioner this morning is Deputy Joe Higgins.

**Deputy Joe Higgins:** Some observers say that the role of the IMF changed significantly from initially encouraging co-operation economically between states and short-term loans for trade to conditionality attached to loans during the debt crisis in the 1980s and early 1990s in what was called the Third World. Does Dr. Donovan agree with that?

**Dr. Donal Donovan:** Conditionality has always been a feature of IMF loans and this is grounded in the legal requirement that if the IMF provides funds to a country, it has to have assurances that those funds will be repaid so that they will come back into the pool - it is like a credit union - and be available for another country potentially later. The basis for conditionality is that in order for the IMF to have such assurances that such funds will be repaid, it needs to be confident that the government is undertaking measures to reform, change and alter the policies that got itself into the problem in the first place. This is the basis of conditionality which has been there since 1950.

The IMF has always applied this approach in its lending activities. The groups of countries to which it lent have varied somewhat over time. There was some lending to industrial countries in first few decades of the IMF ending in the mid-1970s. There was continuous lending to low-income countries in Africa for many years. There was intensified engagement with middle-income countries. The Deputy referred to the debt crisis of the 1980s and, indeed, there were the crises in East Asia, Russia and Argentina at the end of the decade. The pattern of lending to different groups of countries has varied a little bit and now we are back into lending to industrial countries, but the principle of conditionality has always been there.

**Deputy Joe Higgins:** Why did the structurally-adjusted programmes become so controversial in the 1980s and early 1990s?

**Dr. Donal Donovan:** I certainly agree with the Deputy that they were controversial. They were rightly or wrongly - and one could debate this at some length - aimed at modifying policies that had been followed in quite a number of countries, which were - let us call them - relatively regulated policies, that is to say, relatively closed exchange and trade systems, an emphasis on import substitution, an emphasis on state enterprises, an emphasis on wage and price controls and discouragement of private banking activities. Rightly or wrongly, around the 1970s and 1980s, many countries and many in the IMF and the World Bank felt that these policies had



not been successful and had not led to economic improvements in these countries. The agenda - I agree with the Deputy's characterisation - was to try to change these policies. These were politically sensitive; they were politically difficult. Whether they worked well or not is a matter for debate, but I suggest one important point is that there has been one group of countries - it missed all of the terrible mess we have had over the past ten years - which has performed very well and whose economic growth performances overall has been remarkably positive. Those are the African countries over the past 15 years. Many would argue, again rightly or wrongly, that the policy changes they began to implement in 1980s and 1990s were finally bearing fruit and having a positive effect and that this contributed to what has been, which would be agreed by most observers, a surprisingly positive and sustained improvement in Africa's economic performance not just in terms of overall growth, but also in terms of reducing poverty. Of course there is still poverty in Africa but on a wider range of indicators, the results could be regarded as quite positive.

**Deputy Joe Higgins:** Obviously, I cannot debate the issue with Dr. Donovan but given the horrific poverty and breakdown in Africa, some people would not agree with his assessment. Joseph Stiglitz, a world famous economist and recipient of the Nobel prize in economic sciences, said the following in his book *Globalization and Its Discontents*:

The IMF is not particularly interested in hearing the thoughts of its "client countries" on such topics as development strategy or financial austerity. All too often, the Fund's approach to the developing countries has had the feel of a colonial ruler.

What does Dr. Donovan say to that?

**Dr. Donal Donovan:** I would say that I would not quite share that characterisation by Professor Stiglitz, and I would not be alone in that view. The issues have been debated and will be debated widely and extensively. His view is one-sided and I do not agree with it. Of course countries are independent. To refer to anything coming from Britain, France or the United States as coming from an ex-colony - that may be the case. It is true that the IMF is run by those who contribute the most money. Again, that is the way it is. Those countries tend to be countries that are large and have had perhaps a colonial history so it is easy enough to say that the IMF is ex-colonial powers coming back again. I am not sure that is helpful.

**Deputy Joe Higgins:** Are they the countries that have headquartered the major financial institutions in the financial markets? They had most to lose or gain in the structurally adjusted programme situation.

**Dr. Donal Donovan:** Financial markets now are fairly well dispersed throughout the world. They are in Europe and in America and I am sure there are some in Asia. It is not sometimes clear where exactly someone is headquartered. One may be headquartered physically in a country but, in fact, one's financial operations may span several countries and continents. Yes, the IMF is headquartered in Washington which is not a major market financial centre but of course the political headquarters. The ECB is in Frankfurt and wherever. I am not sure what that tells me, personally.

**Deputy Joe Higgins:** Global Exchange, which describes itself as an international human rights organisation dedicated to promoting social, economic and environmental justice, observed in relation to the IMF's dealings with countries that have debt issues that the IMF ensures that poor countries made debt payments "by requiring countries to cut spending on education and health; eliminate basic food and transportation subsidies;... privatize national assets;

and freeze wages.” Does Dr. Donovan believe that to be true?

**Dr. Donal Donovan:** I would not agree with that characterisation and I would make a couple of points, very briefly. First, sustained macro instability in terms of financial problems, large budget problems and large debt problems are not conducive to any country, including low income countries, improving their growth performance in such a way that the country will then have more resources to pay for exactly the areas mentioned by the Deputy, namely, education, health and other matters. It is difficult to spend money when one is poor because one does not have money. What one needs to do is to try to get resources going into the country and one will then be in a better position to deal with these very pressing problems.

On the debt issue, in fact, the IMF has been strongly supportive of what is known as the highly indebted poor countries initiative, HIPC, which ended up, with the urging of the IMF, and it took some persuasion for others to join in, cancelling most of the debt, including the debt owed to the IMF and the World Bank, of the poorest and most highly indebted countries in the world. This was a very important step that took place about ten years ago. It led to precisely the positive effect that the Deputy mentioned, namely, the availability and release of resources for these activities. In terms of the characterisation of the IMF as squeezing blood out of a stone or extracting money from poor countries to pay debt service at the cost mentioned by the Deputy, I would not agree with that characterisation.

**Deputy Joe Higgins:** Does Dr. Donovan agree or disagree with the following observation, that the IMF routinely pushes countries to deregulate financial systems and that the removal of regulations that might limit speculation has greatly increased capital investment in developing country financial markets?

**Dr. Donal Donovan:** There is some truth in that, yes. I think the IMF, as I mentioned in my statement, was a creature of its member countries. Clearly, throughout much of the world in the period over the past 20 years, there was a general movement towards deregulation of financial markets and elsewhere. The IMF certainly did not push back in the opposite direction. It tended to support that, as its members countries, who after all do run the IMF and we should not lose sight of that, pushed in that direction. It is well recognised, and we do not have to dwell on it, that went far too far in the case of financial regulation. I think the IMF and its member countries would fully agree with that criticism.

**Deputy Joe Higgins:** Professor Black, in his testimony here, evidenced the policy of the United States in the 1990s when the Administration, he says, pushed quite extensive liberalisation in the financial area. However, Dr. Donovan, on page 2 of his opening statement, said:

As an overall comment, I think it is widely accepted that the IMF’s surveillance process failed in Ireland. Although, as discussed below, some vulnerabilities were noted, the assessments by the IMF staff gave no inkling that a major disaster could be in the making. Adjectives such as “exceptional”, “remarkable”, “highly impressive” were used throughout the first seven years of the decade to describe Ireland’s overall economic performance.

On page 5, he asked, “Why did the IMF team get things so badly wrong?” and suggested a few explanations. On page 6, he said:

These were serious shortcomings, to which can be added the general approach at the time that favoured so-called principles-based, what is sometimes called light touch, financial regulation. The IMF, being a creature of its member countries, was undoubtedly heav-

ily influenced by this prevailing philosophy.

Could it be that the explanation for the failure of the IMF to identify what was going on in Ireland, in reality, and the use of the adjectives “exceptional”, “remarkable” and “highly impressive” were used during the bubble because the financial deregulation, privatisation and free reign given to major financial institutions in Ireland in fact made the country the star pupil of the IMF policy and the policies of the dominant countries within the IMF?

**Dr. Donal Donovan:** I am not sure I would quite go as far in that direction. The absence of appropriate financial regulation, and I think we all agree on that at this stage, was an important factor underlying the banks disaster and it led to all this lending for property, etc. that was too risky and uncontrolled. Here is a key point, and I think I share the Deputy’s view, that this provided a false picture of the strength of the Irish economy because we were seeing these growth rates of 5%, 6% or whatever per cent in the first half of the decade that were not based on underlying export growth as they had been in the years prior to the millennium - the true period of the Celtic tiger perhaps. These growth rates were heavily based on construction - on a construction boom and on a construction bubble. In that sense, the rosy picture of the IMF, painted by the IMF which said the economy seems to be booming along, continuing to grow and still among the highest growth rates in Europe, if not highest, I agree with the Deputy that that in itself was based on a lack of appreciation of the property bubble nature of this. Then one can say that the property bubble nature of this was in turn a good part influenced by the approach to financial regulation. In making those connections, yes, the rosy picture was linked indirectly but definitely to the deregulation.

**Deputy Joe Higgins:** Following on from the bubble and the inevitable crash, Global Exchange, which I mentioned earlier, alleges, first, that in regard to the IMF approach to the peso crisis in Mexico in the mid-1990s, and to the Asian countries, “...the IMF required governments to assume the bad debts of private banks, thus making the public pay the costs and draining yet more resources away from social programs”. Does Dr. Donovan agree with that?

Second, if the IMF therefore could be held responsible for encouraging moral hazard on behalf of the major international financial institutions by having them realise that they could be bailed out if they go over into a crisis, would it take any responsibility, some responsibility or none for this situation, the risks that were taken and the type of speculation that was allowed to develop of which witnesses like Professor Black here have evidence?

**Dr. Donal Donovan:** On the first point, and I would have to recall the precise details, the solutions to the Mexico debt crisis and the solutions to the East Asian debt crisis did involve restructuring, reorganisation and alleviation of the debts in question. The Deputy is right. It was not simply a question of “Let’s wipe out all these debts” but the programmes, particularly in Mexico I recall, did involve a substantial write-down by creditors of the claims they had on Mexico. This was known, if I recall correctly, as the Brady plan. It would be overly simplistic for an author to say it was straightforward that the IMF required the Governments to assume all of these debts. There were quite a lot of bankruptcies and private sector write-downs.

The second point is a very interesting one and it is something the IMF and its executive board has grappled with over many years. There is a potential moral hazard problem if countries believe that if they get into trouble, the IMF will come along to help. I am not saying they would welcome that because, after all, there is political stigma and huge political costs associated with being associated with the bailout, but the more important point is that private lenders feel that if they get into trouble, the IMF will come along and bail them out. This can create

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moral hazard, and can cause riskier and inappropriate decisions to be taken by private lenders.

This has been wrestled with over several decades. It is not an easy problem. The IMF would wish to try to provide money to countries that are in trouble but the taxpayers in IMF countries do not want to see this money disappearing back out the door to private lenders who should have adopted a less risky policy.

I know this might come up a little later, Chairman, but it is interesting that in the euro debt crisis it is fairly well known that the IMF was quite keen at an earlier stage for some write-down of debt by Greece to be included as a critical part of the Greek programme, and this occurred in 2011 to 2012. It is also no secret that in the discussions on the Irish bailout the IMF, at least the IMF mission here in Dublin, explored quite a bit the possibility of some limited burning of senior unguaranteed bondholders.

The IMF has generally not been opposed to debt write-downs as a matter of principle. There are costs and benefits, but it does not have a philosophical objection to that. It approaches the issue in a pragmatic way and would tend, in my experience, to take the view that if a debt is unsustainable and some restructuring write-downs are needed, then it is better to do that earlier rather than later because if it ends up being done later there are a lot of costs involved in the meantime. It is a more nuanced approach to the handling of debt issues on the part of the IMF.

**Chairman:** I will call Deputy Higgins again as we wrap up.

**Deputy Kieran O'Donnell:** I welcome Dr. Donovan. Dr. Donovan said the IMF failed Ireland in terms of surveillance and asked how it got it so wrong. Dr. Donovan has 30 years of experience in the IMF. He has been involved in missions worldwide. What would he have done differently, and what recommendations could the IMF have made in respect of its surveillance of Ireland before the crisis? In what year should it have identified that there was a crisis looming?

**Dr. Donal Donovan:** I tried to cover some of those points in my statement but if I may, I will summarise the key elements. Yes, the IMF got it badly wrong, and more badly wrong than I have seen in almost any other country, and I do not think the IMF would disagree with that view.

**Deputy Kieran O'Donnell:** Is it fair to say that Dr. Donovan regards it as the worst surveillance mission by the IMF of any country in which it was involved?

**Dr. Donal Donovan:** Certainly the most extreme case. "Worst" is a word I would prefer not to use, but it is very striking and as I said in my testimony, and I am no historian of this, I cannot recall in my experience a situation where the rosy picture turned so negative in such a short period of time.

What could the IMF have done? It pushed for counter-cyclical fiscal policies but with no effect, and repeated it every year.

**Deputy Kieran O'Donnell:** In what year should it have called stop?

**Dr. Donal Donovan:** I think every year since 2000. If the Deputy looks at the reports, there was an urging by the fund staff that the Government should do a bit more. At that stage it was put more in terms of a higher surplus or a lower deficit - one and a half percentage point of GDP or something like that. More important was the collective failure to understand the underlying

nature of Ireland's fiscal position, and this is the so-called cyclically-adjusted balance, the CAB. As far as one can tell, the IMF accepted unquestioningly the Department of Finance methodology, which in turn was based on the common EU methodology.

I am not saying I would have done this but I do suggest that it would have been appropriate analytically for the IMF to say, "Okay, that is what you do, that is what the EU does", and explain what it does and does not imply. The assumptions underling that approach are key and turned out to be flawed but let us change these assumptions and have another look at what the underlying fiscal balance of Ireland might look like in that situation, and it would probably have uncovered that the deficit was quite different. Whether this would have spurred action by the authorities is another matter.

On the financial sector, and looking at the banks, I suggest again some reasons. There were constraints. There were constraints of people. What Professor Honohan and his inquiry did to uncover the true story of what had happened in bank lending took four months of highly intensive work by a small team of specialised people. One cannot expect the IMF team coming to Dublin or to any country in two weeks to get even remotely into that kind of thing, so I am not sure it could have done more.

I do think it should have been more cautious in its assessments. It should not have accepted uncritically the soft landing hypothesis. It should have said, "This might happen but where is the evidence on the CBI's part that this is going to be a soft landing?", and there was not evidence in the 2007 report, as I am sure all the members are aware. There should have been more questioning. It should have been more critical. In terms of how far it could have gone, I think we all realise the environment one is in.

**Deputy Kieran O'Donnell:** Would Dr. Donovan accept-----

**Dr. Donal Donovan:** If the IMF team were to say in the *Sunday Independent* that "we think a property crash is coming in the next six months and prices will fall by 30%", I do not know what the reaction would have been. Would it have been effective or not?

**Deputy Kieran O'Donnell:** Was 2007 too late?

**Dr. Donal Donovan:** In my view, yes. I think that by 2007, and this is the case for the Central Bank, the IMF and other assessments, the damage had already been done.

**Deputy Kieran O'Donnell:** On what date does Dr. Donovan believe the bells should have been rung by the IMF?

**Dr. Donal Donovan:** I think 2004, 2005 and 2006 was when the property bubble and associated lending went into overdrive.

**Deputy Kieran O'Donnell:** In terms of the issue of crying wolf too often, how big a factor was that in the type of public assessment the IMF gave?

**Dr. Donal Donovan:** I cannot give a good answer to that because I do not know the minds of the people and have not had the opportunity so far to talk to them about it.

**Deputy Kieran O'Donnell:** But on page 4 of his statement Dr. Donovan made specific reference to "a fear of being seen to cry wolf too often, since the overvaluation [thesis] had been raised every year since the start of the decade". Dr. Donovan is putting down on the public record reference to crying wolf. I am asking Dr. Donovan about the basis of his assessment in

that regard.

**Dr. Donal Donovan:** I will read the relevant paragraph because I have worded it very carefully and I do not want anyone to give the impression that I have prior information which I do not have. I do not have private information as regards the thinking of the IMF staff. I am just a person who reads these reports and who knows generally how people-----

**Deputy Kieran O'Donnell:** With due respect, Dr. Donovan-----

**Dr. Donal Donovan:** The wording-----

**Deputy Kieran O'Donnell:** With due respect, Dr. Donovan-----

**Dr. Donal Donovan:** Could I just finish?

**Deputy Kieran O'Donnell:** Dr. Donovan had been at the IMF for 30 years.

**Chairman:** I will let Dr. Donovan answer that.

**Dr. Donal Donovan:** The wording is quite important. One should be careful not to infer, perhaps, things that I would not have said or meant. "This cautious stance by the IMF may have been due to several factors...". I did not say crying wolf was a major issue nor do I wish to imply that I know anything about the thinking of the IMF staff or their relations with Ireland, because I do not. However, I am speculating - it is a reasonable thing to speculate on - that this may have been due to a number of factors. It is reasonable to suppose that if a person says every year that there is going to be a house price fall and it does not happen, then people will decide that he or she is saying the same thing again and it is boring and repetitive. I also surmise - I think this is stated in the Honohan report as well as our book - that the same fear or issue may have been present in the case of the Central Bank of Ireland. Again, that is only speculation.

**Deputy Kieran O'Donnell:** Dr. Donovan makes reference in his report to the issue of the commercial property bubble.

**Dr. Donal Donovan:** Yes.

**Deputy Kieran O'Donnell:** This is in page 4 of the report. Does Dr. Donovan believe that if there had not been a commercial property bubble, then there would have been no requirement for a bank guarantee or a bailout programme for Ireland?

**Dr. Donal Donovan:** We see what emerges when we look at the figures and the breakdown in lending to different sectors, including household lending, residential mortgages and commercial property. We can include the lending by foreign subsidiaries of the major Irish banks. As I said in my statement, this matters because if the banks go broke, the subsidiaries have made losses and those losses end up being added to the bank losses. We looked at this extensively in our book. I can point committee members to the page and they can see the table.

**Deputy Kieran O'Donnell:** It will be referred to in the next question.

**Dr. Donal Donovan:** The increase in lending to what I am calling the developer sector was actually much larger than the increase in mortgage lending. It seems to me that if that sector had been looked after, the bill would have been far less. If it had just been residential mortgages, arguably, one could have managed. Yes, there would have been losses, indeed, large losses but-----

**Deputy Kieran O'Donnell:** Does Dr. Donovan believe there would have been-----

**Dr. Donal Donovan:** It could possibly have been managed.

**Deputy Kieran O'Donnell:** Could we have avoided a guarantee if that was the case?

**Dr. Donal Donovan:** Of course, at the time of the guarantee we did not know anything about the state of commercial lending, household lending or mortgage lending.

**Deputy Kieran O'Donnell:** I am asking about it in hindsight.

**Dr. Donal Donovan:** I cannot say. I do not know.

**Deputy Kieran O'Donnell:** Could we have had a soft landing?

**Dr. Donal Donovan:** The soft landing was never for the commercial property market. Development property land, as I understand it, fell by 60%, 70% or 80%, which was way beyond a soft landing or what happened to household prices, which fell by approximately 50% or 60%.

It would be a little misleading to regard these two categories of lending as totally unconnected. The reason developers were building housing estates and related entities in all parts of Ireland and elsewhere is because they thought there would be people who would buy the houses they were building, live there and enjoy the leisure centres and shopping centres close to these houses. In a way, there was some connection.

**Deputy Kieran O'Donnell:** I will move on to Dr. Donovan's book. There is a reference on page 9 to the bank guarantee. The book by Dr. Donovan and Mr. Murphy deals extensively with the bank guarantee.

**Chairman:** Is it in the statement?

**Deputy Kieran O'Donnell:** I am referencing page 9 in the statement, but it is in the book as well. Dr. Donovan stated, "Contrary perhaps to what is sometimes said, it appears from this table that the coverage of the Irish guarantee was not that radically different from that contained in several other earlier guarantees". Then, subsequently, in an article in *The Irish Times* on 5 October, Dr. Donovan said that the guarantee in September 2008 was the least worst option. Can Dr. Donovan tell me of any other guarantee - he said it was not radically different from others - where the level of bank deposits guaranteed, amounting to €400 billion, were over two times GDP or the level of debt taken on by the taxpayer, amounting to €64 billion, was nearly 40% of GDP? Does Dr. Donovan still hold by his assessment that it was the least worst option? Does he believe, in line with his colleagues in the IMF, that bondholders should have been burned? Finally, does he believe that Anglo Irish Bank should have been allowed to fail?

**Dr. Donal Donovan:** Yes.

**Chairman:** I will give you sufficient time to answer that and then I will go on to the next question.

**Dr. Donal Donovan:** There are a lot of very important and complex questions there.

**Deputy Kieran O'Donnell:** They are all interrelated.

**Dr. Donal Donovan:** I will do my best but this might take a little time.

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**Chairman:** If members store up questions at the end, I will move on to the next question.

**Dr. Donal Donovan:** Some of these questions can only be answered with some explanation and in context. Our book refers to the table in the IMF report. It has far more detail and I am happy to provide the reference in the original report, which is on the public record. The Irish guarantee was certainly the most comprehensive in the sense that it included subordinated debt. I can come back and talk about that if people wish. None of the guarantees referred to in the IMF included subordinated debt. There is an issue there, of course.

The coverage in terms of bonds and senior debt was not that dissimilar - I have chosen these words advisedly - to that contained in many other guarantees. I cannot say it was exactly precise because one would have to look at all the legal documents. *Ex post*, it is probably true that the cost of the guarantee, either the *ex ante* cost of €400 billion covered or the *ex post* cost in terms of the €64 billion or €40 billion or whatever the number, was well up there among the highest. I think there are a couple of cases, perhaps Indonesia, where it was pretty high too. I cannot make an exact comparison.

The guarantee is of course very controversial. We examined it for our book and we discuss it at some length. We took the approach that was important to ask if the guarantee was very bad and such a disastrous decision at the time then what other alternatives were available and would they or might they have led to a better outcome. The analysis of this question starts with the proposition that, for good or bad, there was a major agreement among Ireland, Europe and elsewhere that no bank should be allowed to fail in Ireland, for good or bad. I will come back to that again on the question of Anglo Irish Bank, which was the last question that the Deputy raised.

The second key point was that Europe, in the form of the ECB, we assume, had made it quite clear to the Irish authorities in the days before the guarantee the previous week that there was no pan-European solution coming, and that every government, be it in Ireland or elsewhere, had to do whatever it took and whatever was needed to solve its problem. Given those two constraints - they may not be good constraints and they may not be right, but they were constraints - we have looked carefully at other alternatives. We looked at the alternatives of delaying, doing nothing, waiting a week, ELA, nationalising Anglo Irish Bank and excluding deposits. When we go through each of these - I am happy to spend as long as people are interested going through them, but I know there are time constraints - it is difficult to conclude, in our view, that either of them would have led to a materially different outcome at the end of the day, unless one assumes that senior bondholders were going to be burned. Whichever way one looks at the analysis, one comes back to the same point. Are we going to burn senior bondholders? For example, it has been argued that only new debt should have been guaranteed and that existing debt need not have been guaranteed. That is true but it would only have made a difference if, at the end of the day when that existing debt fell due, someone concluded that we were not going to pay it or pay only part of it. In other words, we come back to the burning of the bondholders. Otherwise we would have had to give another guarantee to get the debt rolled over or we would have just paid it, which is what we ended up doing and is where the €64 billion came from. That is the fundamental proposition and, to put this as neutrally as possible, the record of the following four years showed that, for good or bad, the European position was that there was to be no burning of senior bondholders. I am not suggesting that was the right view but it was the view and it did not change. It did not change at the time of the Irish bailout in November 2010 nor in March 2011 and, indeed, it was supported by the United States at the time, as we all know.

**Chairman:** I will need you to wrap up because I will bring Deputy O'Donnell back in at the end of this session.



**Dr. Donal Donovan:** At some stage, Chairman, I would like to come back to the Anglo Irish Bank liquidation issue.

**Deputy Kieran O'Donnell:** This is my last point.

**Chairman:** Can we deal with Anglo Irish Bank very quickly and then Deputy O'Donnell's last question?

**Dr. Donal Donovan:** This is quite important. Yes, the option was to discard the hypothesis that no bank should fail and to allow Anglo Irish Bank to fail - a disorderly liquidation. Of course, nobody knew or believed that Anglo Irish Bank's situation was as bad as it turned out to be at the time. There would have been no particular reason, therefore, to have allowed Anglo Irish Bank to fail because by definition and by assumption it was only facing a liquidity problem. Why would we have closed the door? I believe that the costs if, for whatever reason, Anglo Irish Bank had been liquidated would have been very substantial. I do not want to waste time repeating this but the Honohan report on pages 131 and 132 paints a very striking picture of the huge economic and social costs and disruption if there had been a disorderly closure of Anglo Irish Bank that night or the following morning, both directly and internationally and for other banks and so on.

Who knows what those costs would have been or how big they would have been. I think the case is made, however, and I would make the statement, based on my own experiences with other countries where there have been bank runs and disorderly bank failures, that the costs would have been substantial and they could not have been minimised. Whether they would have been as great as the cost of the €30 billion or €40 billion associated with the bank guarantee is, of course, something that only history can tell. Faced with the possibility of the collapse of Anglo Irish Bank that night if nothing were done, I do not think allowing Anglo Irish Bank to have collapsed would have been the right thing to do and I think it is unlikely that any government would have done that. Many academics and commentators have subsequently suggested what the Government should have done. In my view, people who lead a Government have to be risk averse. They cannot try various courses of action. If it does not work, the academics will be okay, but if one is the leader of a country that is in the middle of a crisis, one has to do things that will not lead to a catastrophe the following morning.

**Chairman:** Dr. Donovan is significantly over time. I want to bring Deputy O'Donnell back in to wrap up. I call Senator Marc MacSharry.

**Senator Marc MacSharry:** I thank Dr. Donovan for coming to see us today. He mentioned earlier that the IMF is run by those who contribute the most money. Do such countries involve themselves in the conditionality of loans?

**Dr. Donal Donovan:** The process is that the staff, which is 98% of the people who work in the IMF, which is what I was, a civil servant - I was a Mr. Mody or a Mr. Chopra - conduct all of the discussions with countries. They prepare all of the analysis and all of the reports. The head of the IMF - Ms Lagarde at the moment - performs two jobs. One, she is head of the staff. She would have been my boss if I was still there. She is also chairperson of the executive board of the IMF. She has two roles. In her capacity as executive board chairperson she takes into account the prevailing broad view of member countries - all of the board members but probably some a little bit more than others, depending on the country. Her job is to approve the negotiating mandate for a team that would come to Ireland. She does that in her capacity as head of the staff. People cannot leave Washington unless there is an agreed position. She takes

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into account what she thinks the broad feeling of the board would be. It is through that process that decisions are made. The views of contributing member countries are definitely taken into account. If, for example, after negotiations, the staff come back with an agreement, it will not be a complete agreement unless and until it is signed off by the executive board of the IMF. The board will discuss the proposal to lend the money and the conditions attaching to the loan. There can often be substantial disagreements among members of the board. Some countries may wish for tougher conditions, others may think that the conditions are not tough enough, and so on. In controversial cases there can be extensive debates. At the end of the day the staff proposal is approved or not, and it is usually approved. The views of the board will definitely be taken into account the next time the staff have discussions. That is the way the process works.

**Senator Marc MacSharry:** I understand the process because Dr. Donovan has outlined it but he did say that the IMF is run by those who contribute the most.

**Dr. Donal Donovan:** Yes.

**Senator Marc MacSharry:** Every country has a representative in the IMF, but, for example, Ireland does not contribute the most money, so is there some kind of qualified majority voting system which allows some countries to be more equal than others?

**Dr. Donal Donovan:** Yes, there is, in the sense that decisions on lending, which are key decisions, require approval of 51% of the votes. The IMF does not take votes explicitly. It very rarely takes votes where people put their hand up. In the sense of a discussion and discussions on difficult cases, most of the representatives of member countries would speak. The secretary of the board has a pretty good idea of the voting capacity of each chair.

**Senator Marc MacSharry:** I am sorry to interrupt but I have only two minutes left and I want to cut to the chase. Do the big boys dictate how the little boys pay off loans?

**Dr. Donal Donovan:** The big boys have more influence than the small boys.

**Senator Marc MacSharry:** Okay, that is fine. We have had testimony this very day, from Mr. Marco Buti of the European Commission, who, when questioned by me, said very explicitly that there was no rule, written or unwritten, no air nor no environment in which it was understood that no bank should be allowed to fail. Dr. Donovan has just said explicitly and clearly that there was an agreement between Ireland, Europe, and the IMF that no bank should fail. What is his source for that information?

**Dr. Donal Donovan:** May I just slightly qualify? I did not say the IMF. The IMF was not involved in this discussion at all, for other reasons.

**Senator Marc MacSharry:** Okay, we absolve Dr. Donovan of that, but Ireland and Europe-----

**Dr. Donal Donovan:** Yes, I think it is quite clearly stated in the Honohan report and the Nyberg report. The authors of those reports and their inquiry teams, of course, had extensive discussions with the specific key persons involved on the Irish side. I think their conclusion, which is stated very explicitly in their reports, was that this was a starting point and that it was a view not pushed on Ireland by the ECB but that was independently held by Irish officials, for good or bad. That was the view and there was only one view. I cannot find immediately the exact parts of the Honohan report but it is very clearly expressed there and I would be happy to provide the references.

**Senator Marc MacSharry:** Just to be clear-----

**Chairman:** A last question, Senator.

**Senator Marc MacSharry:** It is the same question. I will be quick though. Dr. Donovan is referring to Ireland now on that issue and this is important because the committee heard this morning that there was no view in Europe that no bank should fail. There was no policy direction nor no understanding. Dr. Donovan is saying that there was such an understanding between Ireland and Europe. Can I ask Dr. Donovan what his source is for that assertion, from a European perspective specifically?

**Dr. Donal Donovan:** Perhaps I can rephrase it to make it a little bit clearer. Whatever about the European Commission, which Mr. Buti represented, the European Commission is one thing. It was made very clear in the reports that the Irish view long before September 2008 had been that no bank should fail. This view was strongly supported and endorsed and was taken to be the common view within Europe. Certainly, the European Central Bank then and in subsequent years has not made any secret of the fact that no bank should fail in Europe.

**Senator Marc MacSharry:** I have a final question.

**Chairman:** You are way over time.

**Dr. Donal Donovan:** In my view, the evidence is pretty conclusive when one looks at what is written in Honohan and Nyberg and in later public statements by the European Central Bank.

**Chairman:** Okay. I will bring Senator MacSharry back in to add to that briefly. I will have to bring this to an end shortly.

**Senator Marc MacSharry:** Dr. Donovan mentioned Professor Mody earlier on. He spoke on Newstalk radio here in Ireland recently about some sort of debt restructuring. Would Dr. Donovan share his opinions? I am sure he is aware of them. In that context, does he feel Ireland got a bad deal from the troika, including the IMF?

**Chairman:** To be clear, the Senator is asking for Dr. Donovan's opinion.

**Senator Marc MacSharry:** He clarified at the beginning that everything he is saying is his opinion.

**Chairman:** I am clarifying that to assist the Senator.

**Senator Marc MacSharry:** Thanks.

**Chairman:** The use of a term like "good deal" or "bad deal" implies a value judgment. The Senator is putting words into the mouth of the witness. We are looking for Dr. Donovan's own view of the deal. How does he see it?

**Dr. Donal Donovan:** My own view is that we were entitled to and should have got some burning of bondholders in November 2010 and March 2011. I will put it like this: we had a strong case for it. We did not get that because of opposition from the European Central Bank, which feared systemic consequences, and more importantly from the United States, the intervention of which is described vividly by the former Secretary of the Treasury, Mr. Geithner, in a page of his book.

That being said, and this is quite important, the magnitude of the failure to get something

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done on the senior unguaranteed bondholders has been exaggerated, in my view. There was approximately €20 billion of those out there. Perhaps €18 billion is the figure. I have seen reports that have estimated that one third of that was owned by Irish institutions - credit unions, pension funds and investment funds, etc. If one is talking about the net savings that might have accrued to Irish taxpayers, one has to take that out because the burning of these people would have been the burning of Irish people. Maybe €10 billion or €11 billion would have been left at that point. If we had decided to apply a 50% burning rate, on the basis that it was half our fault and half the bondholders' fault, we would have saved approximately €6 billion.

One could get to that number in a different way. If I recall correctly, Governor Honohan did so in his testimony. We could have decided not to burn any bonds held by Bank of Ireland or AIB because they were still in the market, their reputation was important and they were hoping to go back into the market at some stage. We could have decided to leave them untouched while burning 100% of Anglo Irish Bank and Irish Nationwide Building Society bonds that were eligible for burning. It so happens that this produces approximately the same figure - approximately €6 billion - that was mentioned by Governor Honohan, if I am recalling what he said correctly. I stress I am in no sense suggesting that €6 billion is not an important number. Of course it is very important, but we have to remember that it is not €64 billion or €270 billion. The amount of money that could or arguably should have been saved is €6 billion. My personal view is that to hang the whole cost to the taxpayer of the banking crisis on this particular non-event - the veto, if one would like to call it that - is to exaggerate its importance in the greater order of things.

**Chairman:** I call Deputy Michael McGrath.

**Deputy Michael McGrath:** I welcome Dr. Donovan. I will continue with that theme for a moment. Do we know who the holders of the €20 billion of unsecured senior bonds that came out of guarantee at the end of September 2010 were? Another €20 billion of such bonds were secured as they had collateral attached.

**Dr. Donal Donovan:** I cannot say we know. I have seen a couple of newspaper articles which are presumably based on information coming from somewhere.

**Chairman:** I need accuracy.

**Deputy Michael McGrath:** Absolutely. I ask because Dr. Donovan said a moment ago that a certain proportion of the €20 billion of bonds was held by Irish institutions.

**Dr. Donal Donovan:** I have seen estimates saying that they were, but I cannot-----

**Deputy Michael McGrath:** Does Dr. Donovan have a basis for that?

**Dr. Donal Donovan:** I have no independent information.

**Deputy Michael McGrath:** Okay.

**Dr. Donal Donovan:** I am speaking on the basis of that assumption. It is clear that some of them were Irish. We all know that some Irish institutions had significant holdings in Anglo Irish Bank.

**Deputy Michael McGrath:** Okay. That is fine. We know as fact that the figure for the amount of unsecured bonds coming out of guarantee at its end was approximately €20 billion.

**Dr. Donal Donovan:** I believe it is slightly less. I have seen figures like €18 billion, €17.5 billion and €18.5 billion.

**Deputy Michael McGrath:** We have parliamentary questions with those figures.

**Dr. Donal Donovan:** It is around that number.

**Deputy Michael McGrath:** What is Dr. Donovan's understanding of the nature of the efforts that were made in November 2010 during the negotiation of the bailout programme and subsequently when the new Government came into office in the spring and summer of 2011 to impose losses on those senior bondholders? What is his understanding of the nature of the resistance to those efforts? Who did that resistance come from? Maybe Dr. Donovan could put some flesh on those bones.

**Dr. Donal Donovan:** I have no special information on the question of the process. All I have to go on is what others who are more informed and were directly involved have written about the matter. It is fairly clear from Governor Honohan's chapter in the Brian Lenihan memorial book that there was a proposal to undertake some possible burning. It is a very important chapter because he discusses this question in some detail. I ask the committee to excuse me while I try to find the right place in the book in question. I presume the mention of "negotiators on the other side" on page 81 of the book refers to the IMF. It probably does not refer to the ECB, as we know. Maybe the European Commission was somewhere in the middle. I do not know. Governor Honohan states:

Above all, negotiators on the other side dangled, but ultimately withdrew support for, the attractive idea of imposing losses on some bondholders (no longer covered by the original guarantee, which had already expired). It was on Friday 26 November that the Troika staff told Brian in categorical terms that burning the bondholders would mean no programme and, accordingly, could not be countenanced. For whatever reason, they waited until after this showdown to inform me of this decision, which had apparently been taken at a very high level teleconference to which no Irish representative was invited.

What was the teleconference? We can find a reference to it in a book written by the former US Secretary of the Treasury, Timothy Geithner. It is a little bit like a detective story.

**Deputy Michael McGrath:** Can Dr. Donovan call out the name of that book for the record?

**Dr. Donal Donovan:** Yes. It is called *Stress Test: Reflections on Financial Crises*.

**Deputy Michael McGrath:** Okay.

**Dr. Donal Donovan:** I should mention in passing, for good or bad, that Mr. Geithner worked in the IMF for some years. Maybe some people might think that is good while others might think it is very bad. I would like to quote briefly from Mr. Geithner's book, which was published relatively recently:

By Thanksgiving 2010, Ireland's government and banks clearly needed a rescue package. And Europeans were openly debating how deeply to haircut creditors. On another G-7 call, I told them that was crazy.

I am pretty sure this was the teleconference that was referred to in the other book.

**Deputy Michael McGrath:** Was this in November 2010?

**Dr. Donal Donovan:** Yes. Mr. Geithner's book continues:

"You're going to accelerate the run," I said. "Nobody's going to lend to a European government or bank that's showing weakness if they think you're going to impose haircuts as a condition for your rescues. You're undermining your defenses, and it's going to cost you a lot more money in the long run". Trichet was deeply concerned as well, as animated as I had ever heard him. We argued that the Europeans couldn't force countries to restructure their debts until they had a credible plan to protect the rest of the system from contagion ... "You just cannot afford all this loose talk about haircuts", I said. That weekend [following the events described in the earlier paragraph] the Europeans approved an 85 billion euro rescue for Ireland, and changed the proposed design of the permanent firewall. While they didn't rule out haircuts, they agreed not to make haircuts mandatory.

That is all I know about what happened. It is very important to hear from the key participants in the rescue.

**Deputy Michael McGrath:** I have one final question. Dr. Donovan has made what could be regarded as guarded criticisms of the inquiry and its limitations and stated that he does not expect any smoking gun to emerge. Where does he think we should focus our work in order to get the maximum benefit from it? Given that he was part of the Honohan inquiry team, has he any advice or suggestions for this inquiry team as to how it can focus its work?

**Dr. Donal Donovan:** I would not like to be too presumptuous-----

**Deputy Michael McGrath:** We are just asking Dr. Donovan his opinion.

**Dr. Donal Donovan:** -----in suggesting anything to committee members. I think it is unlikely - I may be wrong - that any smoking gun will emerge in the sense that a huge amount of knowledge is available, and written about, on exactly what happened and why, who was to blame and the institutional and other failures. I do not know if anything new will emerge.

I used to think an inquiry was not necessary. This was my view after having worked on the Honohan and Nyberg investigations. However, over the past two or three years, I have come to the opposite view. An inquiry can be very helpful. Why? There are three reasons. There are many people who think there is a conspiracy which is waiting to be uncovered, that there are some dark secrets and a true story of what really happened and that if we had an inquiry we would uncover this. My personal view is that this is unlikely. People, however, need to see that this is the case. They need to be aware that there were catastrophic policy failures, to see it for themselves and to be made aware of it. Not everyone, in fact most people, will not have read the Honohan and Nyberg reports. I am sure very few people will have read our book. This is the first reason.

The second reason is that it is important that the individuals concerned who have, by and large, not appeared on the public record do so, and come and explain what they did. I expect many of them will acknowledge very serious mistakes. It is, again, important for public confidence that this happens. It is a cathartic effect but it is an important one to enable us to get over this whole thing.

The third thing is more of a suggestion. I think I made it in one of my media contributions. In addition to going back over what happened, which is necessary, it would be important if the inquiry in its conclusions addressed the question of what needs to be done to avoid a similar repetition in the future. We all know about lending and property bubbles and banks not being

regulated. We all know this and this will be watched. However, there was something deeper, in my view, happening at the time. There was a failure of the economic policy making process. This involves Government institutions. Risk analysis was not undertaken. Scenarios that were central were too comfortably adopted. There was groupthink and a shutting down of concerns. All of these things were part of the culture in policy making. It would be very helpful if the inquiry were to consider some of these questions and ask itself what fundamentally needs to be changed in the Irish approach to some of these things to ensure that another crisis of whatever source-----

**Chairman:** I will allow the witness to return to this in his concluding remarks because this will be a final issue in the discussion this afternoon. We will move on to Deputy Eoghan Murphy.

**Deputy Eoghan Murphy:** I thank Dr. Donovan for his presence here today. In an article in *The Guardian* in 2011, Dr. Donovan said the IMF was open to rescheduling of debt, whereas the EU was muddling through as it had not been involved in such bailouts before. In respect of the first part of that sentence, the rescheduling of debt, was it previously IMF policy, when engaging in a rescue, to reschedule, restructure or burn bondholders?

**Dr. Donal Donovan:** The IMF, if I may say so, has in general been more open to the concept of restructuring of debt, particularly sovereign debt. Many IMF programmes, which I mentioned in my response to Deputy Higgins earlier, have included this as a very substantial part, as otherwise the numbers will not add up. It is not possible to put the thing together unless creditors take a hit. This is a long-standing feature of IMF programmes.

However, it is not a general principle that always has to apply. One looks at each particular country, because there are costs associated with debt write-downs. Countries' reputations suffer. If one can get away without doing it, it is possibly better. However, if it is inevitable that there is no solution other than including that, the IMF is pragmatic and will say, "Let's do it". It will probably say, "Let's do it sooner rather than later because we are just postponing the inevitable".

I hesitate to speak too much for Europeans but, in various places, I have made the observation that the ECB would have been very reluctant to entertain too much in the line of debt write-downs and restructuring. Why is this? The IMF over 50 years has a lot of experience of what works and does not work. It sees what may have to be done sooner. The ECB is a young institution. It clearly wishes to safeguard its reputation, and having to preside over bank losses or debt write-downs for an institution that is ten years old is not something which would fit too easily with a central bank seeking to enhance its reputation.

The view might also be said by some in Europe who would oppose debt write-downs, at least the ECB, that it is okay for the IMF to say we should probably do this and things will work out better. However, what if the IMF is wrong and the costs associated with this turn out to be much higher than anyone had thought or that the IMF had said might be the case? The IMF people can always get back into their aeroplanes and go back to Washington. However, the ECB is the institution which would have to remain to pick up the pieces if the strategy did not work. For this reason, perhaps there is an element of conservatism on the part of the ECB.

**Deputy Eoghan Murphy:** Is it unusual for the approach to rescheduling not to be taken in this context? In the Irish context, was it unusual for the US Treasury to step in and change the normal approach of the IMF?

**Dr. Donal Donovan:** Every country is different. What happened in Ireland and what happened in the euro area was unprecedented in the history of the IMF and of the world. We had a currency union. We had lending for the first time ever to a member of a currency union. We had extraordinary circumstances as to what was the debt and the size of the debt. We had systemic failure, worldwide panic, Lehman Brothers and contagion. All of these things were unprecedented in the history of the IMF. It was therefore not a question of taking a standard cookie-cutter approach and applying it to Ireland. It could not be and it should not be.

**Deputy Eoghan Murphy:** Moving away from the concept of restructuring and looking at the approach from the EU and the IMF in terms of the actual bailout terms, if we look at the difference in the terms, the IMF loan was provided over a longer period of ten years and at a rate of 3.1%, whereas the EU loans were to be paid over a period of seven and a half years at a rate of 5.9%.

**Dr. Donal Donovan:** I cannot speak about the rationale of the financing terms associated with the EU component, although I understand, if my memory is correct, that when the rescue fund was set up, the idea was that it would be the cost of borrowing the funds from the markets or wherever, plus a margin of perhaps 1% to cover administrative costs or risks or something like this. This produced a number. Subsequently, this formula was changed very substantially, if I am correct, in the case of Greece. The administrative margin was eliminated and there was another way of looking at it. This had the effect of lowering the cost. These are essentially political decisions by the EU.

The IMF is a bit different. There is one formula which applies to all countries. There is a slight difference between very poor countries and others, but essentially there is a formula applied to all countries. It is not a political decision. It is not a question of people in the IMF wondering, "What will we charge Ireland and what will we charge Iceland or Greece?" It is a standard formula based on the average of treasury bill rates, current and prospective, with a margin.

**Deputy Eoghan Murphy:** Dr. Donovan mentioned in his opening statement why the IMF may not have been more explicit when it came to sounding the warning bell for Ireland. He states, "There could have been pressures both within the IMF and vis a vis the authorities to dismiss the possibility of such very negative outcomes." Dr. Donovan says this on page 8 of his opening statement. I know Dr. Donovan is only exploring possibilities, but does he raise it as a possibility because he encountered it in his own work in other countries?

Further to this, when we look at the reports coming from the IMF, we see that it identified a number of the shortcomings and the dangers, as did the ESRI. However, when it came to the reports coming out after the executive board had seen them, we also see it commending performance and talking about a soft landing. There are two points to the question, namely, interference Dr. Donovan may have experienced and then what can we read into the two messages coming out of the IMF reports *vis-à-vis* what the staff were seeing on the ground and what the executive board was reporting back to the Government.

**Dr. Donal Donovan:** This is a very tricky area. IMF staff do not, nor can they, work in a vacuum. They are not just purely technocrats who are not aware of what judgments are being made, what weights people put on risk occurring and catastrophes happening or not, as the case may be. It would be unusual, let me put it this way, for the IMF report to say that a country is doing very well and then for that report to go to the executive board and for many directors at the board to say, "No, no, the IMF is completely wrong. That country is doing very badly".



Alternatively, it would be difficult for the IMF to say that everything is going very badly and the board to say, "No, no. The staff is completely exaggerating the risks and costs. They do not understand. It is going very well." There is a certain - I am not saying "convergence" - way in which the views of board members can and probably should influence to some extent, albeit perhaps somewhat subconsciously, what the staff will write. There are no instructions from the board, there is no question of censorship, but we are all human beings and we get a line of what the general line of thinking is on a country, and that has to exert some subtle influence.

There are often differences of view on the board on a particular case and the staff have to navigate a way through those different views. The staff would have different views among each other. Sometimes, analytical issues and possibilities are discussed quite openly, but when it comes to the final nuanced judgment - adjectives often matter because adjectives are what get reported in the media - some of the sentences in those reports are very subtle.

**Chairman:** There is a level of repetition. I am moving on. We are way over time. I call Senator Michael D'Arcy.

**Senator Michael D'Arcy:** I welcome Dr. Donovan. I read his book. On the bank guarantee, on page 200, he wrote:

The decision provided a comprehensive government guarantee in respect of the financial obligations of the six domestic institutions - Allied Irish Banks (AIB), Anglo Irish Bank (Anglo), Bank of Ireland, Educational Building Society, Irish Life & Permanent and Irish Nationwide Building Society (INBS) - falling due over the following two years.<sup>6</sup>

Footnote No. 6 states:

Foreign banks operating in Ireland [from Dr. Donovan's piece this morning, he described these as foreign subsidiaries]-----

**Dr. Donal Donovan:** Actually, no. It was the other way round. It was lending by subsidiaries of AIB or Bank of Ireland abroad. For example, these banks had outfits in London and these undertook extensive lending.

**Senator Michael D'Arcy:** Footnote No. 6 states:

Foreign banks operating in Ireland subsequently were offered the option of availing of the guarantee for a fee similar to that levied on domestic Irish institutions. However, in the end, they decided not to participate.

Which banks, of which Dr. Donovan is aware, were offered the extension of the guarantee?

**Dr. Donal Donovan:** The Senator should not take this as authoritative, as those involved would be able to give the precise answer, but my recollection is---

**Chairman:** Dr. Donovan should be somewhat authoritative because when names get thrown into the room here, they enter a legal process. We need Dr. Donovan to be authoritative.

**Dr. Donal Donovan:** I am not the right person to answer that question because I might get it wrong.

**Senator Michael D'Arcy:** Then I will explore Dr. Donovan's view on the bank guarantee. We were quoted the gross figure of €64 billion initially. Then Governor Honohan stated

a figure of €40 billion. Would the figure have been higher if those banks that were offered the extension of the guarantee had decided to participate in the offer for them to be covered, and if it had been higher, does Dr. Donovan have any knowledge of the extent of how much higher it would have been?

**Dr. Donal Donovan:** I do not really have the details from the banks. It probably would have been higher but I do not have any view of the extent of the increase. However, it would have been in one direction only.

**Senator Michael D’Arcy:** Billions of euro?

**Dr. Donal Donovan:** As to the size of their operations, they were pretty large. I would imagine, yes.

**Senator Michael D’Arcy:** Tens of billions of euro?

**Dr. Donal Donovan:** I do not want to speculate, if the Chairman does not mind, because I do not have a basis for making a judgment.

**Senator Michael D’Arcy:** In Dr. Donovan’s book, on page 183, there is a chapter entitled, “9.3 Maximizing Liquidity Availability and the NTMA Deposit Episode”. Would Dr. Donovan expand on the NTMA deposit episode?

**Dr. Donal Donovan:** It is discussed quite a bit in the preceding page, page 182, but let me briefly summarise it. Mr. Somers, the former chief of the NTMA, has put all of this down on public record and what we do in that part of our book is simply summarising it. I hope my summary is accurate. For the record, it is probably better to refer to the actual chapter and page.

Basically, what was happening was that the NTMA, it appears, was coming under some pressure or encouragement - whatever the right word might be - to continue to place some of its deposits with Anglo. If I recall, it was a relatively small amount, more like €50 million or less. It seems that the NTMA had some reservations about some of the operations of Anglo. Mr. Somers has explicitly spoken about this.

I am sorry, am I all right, Chairman?

**Chairman:** If Dr. Donovan could deal with the institutions, such as the NTMA and the banks themselves, we can deal with the particular named personalities at a later time.

**Dr. Donal Donovan:** Fair enough. The actual basis for what is said here does come from statements from an individual but I will not mention the individual.

It seems, from the evidence, there was some resistance to this and in the end, it required a ministerial directive which is provided for under the arrangements regarding the NTMA for this deposit to be continued. That, in brief, was what happened, but there were some twists and turns along the road which are described in part of our book.

**Senator Michael D’Arcy:** Could the NTMA have disallowed the option of placing funds into Anglo Irish Bank, if it had decided against it?

**Dr. Donal Donovan:** I understand that the law is quite specific. If a ministerial directive, which is a precise legal instruction, is provided to the NTMA to undertake a certain action, as it was in this case, the NTMA is required to take that action.

**Senator Michael D’Arcy:** I refer Dr. Donovan to page 195, the second last paragraph.

**Chairman:** Briefly, the Senator is on six minutes.

**Senator Michael D’Arcy:** It states:

The NTMA reluctantly complied with explicit government instructions. However, one can conjecture as to what might have happened if the NTMA, given its considerable professional experience and standing, had sought to press at high levels its significant misgivings with respect to Anglo.

Would Dr. Donovan discuss that further?

**Dr. Donal Donovan:** It is, again, fairly speculative. I suppose-----

**Senator Michael D’Arcy:** It is Dr. Donovan’s book.

**Dr. Donal Donovan:** Yes, but the conclusion is still speculative. It seems to me a question can be raised. If an institution which has, for whatever reasons, significant concerns or doubts about a particular institution were to find a way to convey those doubts to Merrion Street or whoever, that might have been an important wake-up call. Of course, that is not the NTMA’s job to do, but it could have perhaps taken an initiative to do so. Whether it would have been listened to or not, and whether it would have been told to mind its own business, is very difficult to say.

**Chairman:** On Senator D’Arcy’s question, what period are we talking about here?

**Dr. Donal Donovan:** We are talking about the period from late 2007 to 2008.

**Chairman:** It is pre-guarantee.

**Senator Michael D’Arcy:** It is pre-guarantee.

**Dr. Donal Donovan:** During the 2007-08 period, there were various exchanges that have been reported on this matter, in the media and by individuals.

**Senator Michael D’Arcy:** Should the NTMA have offered that view to the Department of Finance?

**Chairman:** Senator D’Arcy is over time. I call Deputy Phelan.

**Deputy John Paul Phelan:** I thank Dr. Donovan. I have a couple of questions about the executive board that he referenced in a number of his answers and on page 1 of his statement. Dr. Donovan states that each country is represented. How is each country represented on the board?

**Dr. Donal Donovan:** There are 26 seats on the executive board. Six or seven of those are occupied by an individual country - that is to say, the US has a seat, along with France, Germany, Japan, Russia, China and Saudi Arabia. The list has varied slightly over time. There are, of course, 187 members in the IMF, so the rest of the countries group themselves into constituencies. The chair is occupied by a representative of that constituency. Ireland has always been in a constituency with Canada and a number of Caribbean countries. The head of the constituency is the representative of the Government of Canada, who sits on the board. If he or she is not available for whatever reason, then the alternate executive director, which by tradition and

agreement has always been an Irish person, sits there instead. The alternative executive director is appointed by the Irish authorities. It is a political appointment in that sense. It has nothing to do with the staff - people like me. The tradition in Ireland has always been that this rotates between a Central Bank person and a Department of Finance person. For example, the present alternative executive director is Mr. Michael McGrath, who I am sure is well known to the committee. He is a former senior Department of Finance official. Before that it was Ms Mary O'Dea, who was a former consumer director of the Central Bank.

**Deputy John Paul Phelan:** Following on from that, how did it come to pass? I am looking at the list, which includes Antigua and Barbuda, Bermuda, the Bahamas, Barbados, Belize, Dominica, Granada, Jamaica, St. Kitts and Nevis, St. Lucia and St. Vincent and the Grenadines. It seems like a very strange constituency for Ireland and Canada to find themselves in, concerning the executive board of the IMF.

**Dr. Donal Donovan:** Countries are free to, and do, negotiate among themselves. There is an awful lot of toing and froing about how they decide to group themselves. That process is far removed from people like me on the staff. It is very political. We have nothing to do with it, so I do not know how it came about, but I believe it goes back a long way. When I joined the IMF in 1977, the constituency was then what it is today. I would say it dates from the founding of the IMF, perhaps.

**Deputy John Paul Phelan:** I want to ask about the overall tenor of Dr. Donovan's statement today on how the IMF's analysis failed Ireland. It has also been quoted by other members. Dr. Donovan went on to refer in detail to absences from the analysis, particularly with regard to commercial property and what he referred to as CAB, the cyclically adjusted balance, which has a different connotation from what we would normally be used to. What purpose does the analysis actually serve if, on the one hand, as Dr. Donovan said on page two, it is not binding and, also, is not referenced to the member states afterwards? Pretty damning evidence has been given by Dr. Donovan today as to its effectiveness. What is the point of the analysis taking place at all if it has been that ineffective?

**Dr. Donal Donovan:** There are two different questions. The first is whether the analysis is appropriate in terms of coverage, depth and so on. The second is whether any notice will be taken of it. They are two slightly different questions. The issues I discussed here were essentially to do with the faulty analysis or incomplete analysis of the IMF part. Whatever the analysis is, whether it is good or bad, it may have some impact. In the case of Ireland, the positive indications given as to the state of the financial sector were somewhat counterproductive, as the Governor of the Central Bank, Patrick Honohan, said, because they provided a message of reassurance when that was not appropriate.

More generally, there is a problem in that although the IMF's advice is published and the views of the executive board - which usually endorse the staff views, but not always - are published, governments can and do ignore this advice. Sometimes they disagree with it. This is quite common in the UK, for example. Over the years, the UK Chancellor has often said: "That's an interesting report. I agree with much of it, but I strongly disagree with a, b and c." It could be argued, therefore, that a positive role of the IMF is to encourage public debate, encourage exploration of issues and encourage greater public awareness of matters, and to do so indirectly through peer pressure. If all the other countries say to one country, "Your country is really doing bad things. Our collective view, based on experience, is that you should change the policies," that country may say, "Maybe these people have something to say."

**Deputy John Paul Phelan:** In Dr. Donovan's experience, has that ever happened in a developed country?

**Dr. Donal Donovan:** If it happened, the government that changed its policies would not admit that it was because of IMF influences.

**Chairman:** A last question, Deputy Phelan.

**Deputy John Paul Phelan:** My last question relates to the cyclically adjusted balance, to which I referred. Dr. Donovan referred to Professor Honohan's report. Some 30% of the total tax take was from cyclical taxes, primarily related to property. How is it that the IMF failed to notice that? Can Dr. Donovan elaborate and say whether that has been corrected sufficiently?

**Dr. Donal Donovan:** I think it would perhaps be going too far to say the IMF did not notice it. It did have some references to the question of broadening the tax base, which can certainly be interpreted as reducing the dependence on the taxes in question. I think I referred to that in my statement. However, this was not highlighted. This was not given, at least in my view, sufficient emphasis. It was not put up front and centre as a major issue, and I think that was unfortunate. I do not know quite why that was not highlighted. I would have thought that, as a minimum, it would have been appropriate for the IMF to explore the sensitivities of revenues to alternative states of the world, including one in which all or most of the taxation income from the property sector disappeared. That might have sounded greater alarms. However, it did not do so, and I am not quite sure why.

**Chairman:** I am going to move on, because we are way over time.

**Deputy John Paul Phelan:** Has it been corrected?

**Dr. Donal Donovan:** In what sense? I am not sure I quite understand the question.

**Deputy John Paul Phelan:** Does Dr. Donovan feel that if an analysis were to be carried out on country X now, alarm bells would ring?

**Dr. Donal Donovan:** Yes, I think, in a general sense. The IMF went through a lot of soul-searching on this. It published its own report on the failures in the period up to the crisis. It was very candid and made no bones about it. There were problems of groupthink being captured by all kinds of philosophies about deregulation and so on. All of these problems were laid out. I hope that in the future this lesson will have been learned. One always hopes that.

**Chairman:** I need to move things on, because this committee room is scheduled for use at 2.30 p.m. and we are way over time for both sessions today.

**Senator Sean D. Barrett:** I welcome Dr. Donovan. Does he think the design faults in the euro played a part? Does he think we were aware of that role? How did a very conservative banking system give the IMF the biggest bust it ever had?

**Dr. Donal Donovan:** The design flaw is probably fairly well known. The Stability and Growth Pact, the original one, had two essential problems. First, some large countries were allowed to break the rules and get away with it. Of course, if that happens, then everyone else says, "We can't be too worried about that. We will do the same." The second problem was more fundamental - the problem of the cyclically adjusted balance - in that the Stability and Growth Pact either did not refer to the structural balance or, if it did, it got it wrong because it measured it wrongly. There was nothing in this EU-wide system which was going to detect the

massive flaw in the Irish budgetary position. This was true, I understand, to a significant extent in a number of other countries, such as Spain.

The second design flaw was the absence of centralised bank supervision or transnational bank supervision. There were reasons for this, political and others. Everyone was supposed to look after their own banks, but the problem was that when the banking crisis came, whatever we had thought about fiscal stability or the Stability and Growth Pact, it was immediately torn up. That was because, when one has bank failures, inevitably, to some extent, governments find themselves with an obligation to at least put in some fiscal resources, so the fiscal ceiling goes out the window.

Those were the two fundamental flaws. They have been tackled to a significant extent in the reforms. We may have to wait until some stresses and strains appear in the system before we know how solid those reforms are and how firmly they will stick if the going gets a bit rough. We do not know yet.

**Senator Sean D. Barrett:** You say the IMF had no inkling of the indecisiveness and lack of firm engagement underlining the detailed interaction between the Financial Regulator and key financial institutions, problems that you and Professor Honohan discovered only later. Would it have been better if we had had a separate Financial Regulator? The IMF would then have been able to say “We met an institution that was not doing its job,” rather than “We met a bit of an institution and some of it might have been doing its job but it was all okayed by the Central Bank.” We have had some evidence that this task should not be performed by central banks.

**Dr. Donal Donovan:** The merits of the structure were much debated in the history associated with this. There was the McDowell report and then there was an uneasy compromise which led to the architecture that prevailed until 2009. This was messy, but the Honohan report makes a fairly strong argument that, while it was inconvenient and caused some complications, it was not a significant factor underlying the regulatory failure and Central Bank oversight failure. With regard to the IMF assessment, it did meet, very extensively, with the Financial Regulator component in Dame Street, and much of its detailed analysis would have been based on data provided by the Financial Regulator. They would have discussed the state of the banks. I am not sure the messy division of labour really lay at the heart of the weakness of their assessment. There were other reasons, which I refer to in the statement. That said, I think we all know it is much better to have the present structure, which came into place soon after, in 2009 - just one institution.

**Senator Sean D. Barrett:** Ireland and Canada, when they were sitting together at the IMF, obviously never discussed banking, because Canada did not have a banking crisis. Did we learn anything from sitting with the Canadians at the IMF?

**Dr. Donal Donovan:** That is true. It is interesting. Canada has been quite justifiably proud of the fact that among all the major countries, its banks seem to have withstood the shocks. It has a somewhat different banking system, although I will not spend time on that. It is true that the Canadian executive director would have come to Ireland, by the way; although it was the Irish consultation, one would normally find that the head of the constituency would be part of the process in Dublin. Whether the Canadian executive director might have raised questions about the state of the Irish banks based on his own knowledge of the Canadian system is a fascinating question. I do not know.

**Senator Sean D. Barrett:** Finally, I ask Dr. Donovan whether he sees a parallel between

two instances. He said that dialogue between the IMF and the Irish authorities did not take place in 2008, and there seemed to be a similar breakdown in communication, according to the Honohan report, when the Central Bank disappeared from the picture in early September and did not really come back in until the letter from the Governor on 18 October. Does that indicate complete disarray in public administration over that period - a lack of communication and a lack of dialogue?

**Dr. Donal Donovan:** Of course the IMF question is a different one. Regarding the interactions in the period up to the guarantee, August is a month when a lot of people are away. One senior person was unavoidably away because of personal circumstances. In early September, there was, as I understand it and as described in the Honohan report, a concerted effort to ensure that the Department of Finance, the Central Bank and the regulator were meeting frequently to deal with the crisis, but of course the crisis was moving very fast, and preparations had not been as great as they should have been. The tsunami came too quickly to get out of the way or to have protection.

**Senator Susan O’Keeffe:** Professor Honohan, in his report, summarises by saying, “It is clear that a major failure in terms of bank regulation and the maintenance of financial stability failure occurred.” As a member of that team, you obviously agreed with the findings of this report. What would you say about the fact that no one resigned, nor was anyone asked to resign, given the strength of that statement?

**Dr. Donal Donovan:** That is a good question. It does not seem to be the case in the Irish tradition that whatever individuals may have been in charge at a particular public institution when there were policy failures see it as their duty to move aside, nor is it suggested to them that it is their duty. That is a broader question about how we assess collective responsibility, and individual responsibility. Ministers take decisions, but what is the role of civil servants? It is a very big issue. In the case of the banks, though, there was a certain - or, more than certain, a fairly substantial - move towards encouraging those who were perceived to be responsible to move on. That happened to a fairly substantial extent. The issue of civil service and responsibility is a deep one, and I do not know the answer to that question. In the IMF, decisions are taken collectively. There is huge internal debate among the staff, more than many people might think. It is not a monolithic institution at all. Ultimately, however, it is a collective institution, so one cannot say Mr. X was personally responsible for a decision on whether to burn bondholders, for example. That is not the way the IMF works, for good or bad.

**Senator Susan O’Keeffe:** Dr. Donovan said in his own statement that the cautious stance by the IMF may have been due to several factors, including “difficulties in challenging definitively the Irish authorities”. What do you mean by that?

**Dr. Donal Donovan:** If you were to go into it a little bit more, the Irish argument was “We are in a different world.” House prices are permanently higher and the whole environment in which we were operating was different. I had earlier described these fundamental factors. The problem is that it is very hard to model these factors explicitly. Obviously they were present to some extent - a significant extent - but to say “Well, they explain 50% of the increase in house prices and the other 50% is bubble,” was very difficult. It could have been 60% or 70%. There was a lot of debate about this, which can be seen in the reports. The IMF would say it looked at the fundamentals but the Irish authorities said “Yes, but you have not taken into account confidence factors, the return of emigrants or the number of immigrants.” All of this was used to back up the suggestion that we were going to grow by 5% or 6% for the next five or ten years. What I am saying is that this debate was always going to be a little bit inconclusive, and that is

how it ended up. One side did not really convince the other side.

**Senator Susan O’Keeffe:** You say very clearly that analysis of the financial sector always featured in the IMF reports, unlike the European Commission reports, which did not do that. Given what the IMF said about the financial sector - that it was in good nick, if you will excuse the expression - is it possible that the IMF was lied to by the banks?

**Dr. Donal Donovan:** No, I do not think it was.

**Chairman:** Senator O’Keeffe, you know the rules. You know from your own experience the problem with accusations of lying.

**Senator Susan O’Keeffe:** I said, “or not.”

**Chairman:** Please. Actually, I will ask you to withdraw the question and put it again.

**Senator Susan O’Keeffe:** How did it arise-----

**Chairman:** Can you reformulate that question? I do not even want it on the record.

**Senator Susan O’Keeffe:** How did it arise that the IMF, which always did this work - as Dr. Donovan said, analysis of the financial sector always featured in IMF reports - gave us an opinion about Ireland that clearly was not the case? Professor John FitzGerald, when he was here last week, said that while the ESRI also did not look at the financial services sector - he used the words “in or about” - it would actually have been quite easy, had it looked at that sector, to see what there was to see. He did use that terminology - forgive me; I do not have the quote - but he did say it would have been easy. If it would have been easy for the ESRI why was it not easy for the IMF?

**Dr. Donal Donovan:** It is a fair question. Mr. Nyberg said something very similar in his report. He said - I am paraphrasing - that it should have been obvious to anyone who had some experience with financial market behaviour that questions needed to be raised about what was happening in the banks.

**Senator Susan O’Keeffe:** Indeed. Why did this not happen?

**Dr. Donal Donovan:** It is a very fair question. People did not ask those questions. I can only say that in the case of the IMF, I have listed some of the explanations - I would not use the word “justifications” - at the end of page 5 of my presentation. The neglect of commercial property lending, for example, is a very important issue that has come out more clearly. Why did the IMF not look at the massive increase in developer lending? I have heard two reasons being mentioned. Of course there is no good explanation. First, many of these developers had properties in different parts of the world. They had different kinds of properties in different markets. I believe the view held by the regulators was that, while one part of this market might fail, or one type of product might fail, it would be unheard of for them all to go down together, since they were scattered in different places. It was argued that this had never happened before in a property market. I think that was an element. Second, nobody knew anything about the kinds of things that appeared in the section of the Honohan report dealing with what was really going on in commercial property lending. Given that nobody knew about the problems with bank guarantees and inadequate documentation, it would not have been reasonable for the IMF to have known about them. That was a big factor behind the property development collapse.

**Senator Susan O’Keeffe:** Is there-----



**Chairman:** Thank you, Senator.

**Senator Susan O’Keeffe:** I cannot possibly be out of time.

**Chairman:** The Senator’s seven minutes have just elapsed. I call Deputy Pearse Doherty.

**Deputy Pearse Doherty:** I had better speak fast. Rightly or wrongly, there has been a kind of narrative in this State for quite a while that we lost our economic sovereignty and that the IMF dictated the terms as part of the troika. As a people, we have heard some of Dr. Donovan’s IMF colleagues who were involved in the mission in this State recounting their own views in the media. That happened again this week. I would like to ask Dr. Donovan about what his IMF colleague, Dr. Ashoka Mody, had to say on Irish radio - I think it was Newstalk - about the troika deal. I want to quote him directly. When he was asked whether he thinks Ireland’s new Government missed an opportunity to strike a deal, he said:

Absolutely. The new Government had so much going for it .... There were clear mistakes that were made for a decade at least when this new Government came in. There was a burden of debt that would legitimately be declared as an odious debt.

I would like to ask Dr. Donovan, on the basis of his knowledge, his experience and his workings in the IMF, whether he subscribes to or dissents from the view put forward by Dr. Mody that Ireland had an opportunity to negotiate the terms with the IMF and other members of the troika.

**Dr. Donal Donovan:** I should say firstly that I have been asked this before. Dr. Mody has spoken on a number of occasions over the past two years. It is very unusual for a recently retired former member of a team that was heavily involved in negotiations, which were still ongoing when he first spoke, to discuss on the public record his views on the decisions that were or were not taken. Having being associated with the IMF for almost 40 years, I cannot recall any such case in my experience. I just wanted to give my personal view, which is that it was quite unprecedented. One can argue about the merits of it, but I thought I should say that to convey how the IMF works. I think I was asked the substantive question asked by the Deputy on a programme yesterday morning. It would not be correct to say that Ireland did not try to negotiate a deal with respect to the famous €20 billion relating to unsecured, unguaranteed bondholders. By all accounts, this was certainly raised and pushed quite hard in November 2010, but it was rejected for good or bad reasons.

**Deputy Pearse Doherty:** Can Dr. Donovan explain his comment about this being “pushed quite hard”? What is his understanding of how it was “pushed quite hard”?

**Dr. Donal Donovan:** I do not know the details. I can refer only to the Governor of the Central Bank, Professor Honohan, who was present in all of these discussions, whereas I certainly was not-----

**Deputy Pearse Doherty:** Can I just clarify-----

**Dr. Donal Donovan:** He has made it quite explicit that this proposal was there. It was being discussed but then it was vetoed.

**Deputy Pearse Doherty:** Can Dr. Donovan clarify that in light of the evidence he gave earlier? Is he suggesting that one conference call equates to being “pushed quite hard”? Is that the only evidence he has to back up his statement?

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**Dr. Donal Donovan:** It has been widely reported that a proposal that was on the table and was discussed received at least some possible support from the IMF mission that came here to negotiate in November 2010. This was confirmed in Professor Honohan's own words in a paragraph of the book from which I quoted earlier. I refer to the Brian Lenihan book, rather than the Geithner book that mentions the teleconference. I assume this is-----

**Chairman:** That has been laid down here as well. In Professor Honohan's earlier engagements with this inquiry, the issue of revisiting this during the nexus phase was discussed. It is already a matter of record.

**Dr. Donal Donovan:** Yes, I realise that. I want to reiterate briefly that this is my source. I think it is an important source because two of the key figures who were involved in this have gone on the record to describe what happened.

**Deputy Pearse Doherty:** I am probably half way through my time at this stage. When Dr. Mody was asked whether the Government missed an opportunity, he responded by saying "absolutely". He went on to say "there was a burden of debt that would legitimately be declared as an odious debt". Is that something to which Dr. Donovan would subscribe or from which he would dissent?

**Dr. Donal Donovan:** I do not subscribe to the second part because I think the term "odious debt" has a very particular connotation. It is associated with debt incurred by dictators in certain countries before being used for their personal gain and spirited to Switzerland. I would quite strongly disagree with the use of that term. I do not agree with the characterisation in the first part of the Deputy's question. If one says that an opportunity was missed, one is suggesting the opportunity that existed was obvious and easy to take, but somebody missed taking it. That is how I understand that sentence. That was not what actually happened. In November 2010 - and again in 2011, which has been widely reported too - the Irish authorities tried but they did not succeed. It was not for the want of trying.

**Chairman:** I ask Deputy Doherty to put his final question.

**Deputy Pearse Doherty:** I want to go back to the question of "odious debt". It is a bit frustrating that we have not even got past this first question. Dr. Donovan said that the term "odious debt" is usually applied to dictators, etc. I would like to refer to the quarterly magazine of the IMF, which talks about "the legal doctrine of odious debt". It suggests that "sovereign debt incurred without the consent of the people and not benefitting the people is odious and should not be transferable to a successor government, especially if creditors are aware of these facts in advance". Does Dr. Donovan believe that Dr. Mody would be familiar with the international concept in law of "odious debt"? Why would he make such a claim? Does Dr. Donovan believe odious debt is not what the IMF's *Finance and Development* magazine has outlined that it is, but instead belongs to dictators?

**Dr. Donal Donovan:** I cannot say whether Dr. Mody was referring to, or intended to refer to, the legal definition or to the commonly used phrase. The term "odious debt" has been around for quite a long time. It is commonly used by people in the international community to refer to a particular kind of debt that was incurred to buy weapons or arms or to secrete funds in Switzerland. I am not disagreeing with the definition the Deputy has read. It is the first time I have seen it. I cannot say what Dr. Mody was referring to.

**Chairman:** We need to wrap it up.

**Deputy Pearse Doherty:** Would Dr. Donovan subscribe to that definition, or would he dissent from it?

**Dr. Donal Donovan:** Is the Deputy asking whether I believe it refers to Ireland's debt?

**Deputy Pearse Doherty:** No. I am asking whether he subscribes to that definition of "odious debt".

**Dr. Donal Donovan:** I am not a lawyer. If the lawyers say that is what it means in international law, I would not quarrel with their definition by any means.

**Chairman:** Before I bring matters to a conclusion by bringing in Deputies Higgins and O'Donnell, I would like to clear one or two matters up with Dr. Donovan. I welcome his comments and views on the inquiry and the work it is doing. His position seems to have evolved from his earlier one. Has Dr. Donovan's position on the guarantee evolved, or is it very much what it was? He previously suggested in the middle of the crisis that it was the best option and the best solution, regardless of hindsight. He seems to be presenting a view to the inquiry this morning that the guarantee as it was implemented was the best option. Is that a correct reading of Dr. Donovan's presentation?

**Dr. Donal Donovan:** The debate on this issue has raged, is raging and will continue to rage. In the context of the analysis and the conclusions - which are difficult to summarise in one sentence and which are contained in our book - I would continue to hold that view. When one considers all of the alternatives, namely, waiting, doing nothing, letting Anglo fail or using large-scale ELA, I do not have an axe to grind here, but my honest view is that I have yet to see a strong set of alternative proposals which would have been likely - this is a matter of judgment - to have led to a better outcome at the time, particularly in light of the state of knowledge and the costs associated with bank failures, than the guarantee. Of course, the guarantee is terrible and nobody is suggesting otherwise. We all know the costs associated with it.

**Chairman:** The IMF does not do guarantees; it does bailouts. Dr. Donovan has 35 years' of experience of IMF interventions, etc. In his view, did the way in which the guarantee was designed have anything to do with Ireland being obliged to enter a bailout programme some two years and two months after its introduction?

**Dr. Donal Donovan:** I am sorry; I did not quite catch the last part of the Chairman's question.

**Chairman:** Was how the guarantee was designed in any way related to Ireland entering a bailout programme two years and two months after its introduction?

**Dr. Donal Donovan:** It is a very speculative question. Clearly, the guarantee led to the high costs which, together with the disastrous budgetary situation, is what finally brought the bailout. If the guarantee had been different and if some bank had been allowed to fail, either completely or partially, who knows what would have happened? The immediate direct financial costs would have been less to the extent that they would not have included whichever bank or banks' liabilities were written down or burnt.

**Chairman:** Does the bailout have a relationship to the guarantee at any significant level?

**Dr. Donal Donovan:** Not in a direct sense. The bailout was the result of Ireland's insupportable debt problem. We had a huge budget deficit that could not be financed because nobody

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would lend to us by November 2010. Why was that? We had a major budget problem that was quite independent - I must stress this point - of the size of the banking debt. It was simply to do with the difference, on a day-to-day basis, of running Government. That was one component. On top of that were the costs which stemmed from the guarantee. If the €64 billion had been less - for example, if it had been €40 billion - I do not know-----

**Chairman:** Do the bailout and the guarantee have a relationship to one another?

**Dr. Donal Donovan:** The effect of the guarantee was to create the conditions, among other things, which led to the bailout.

**Deputy Joe Higgins:** Earlier, Dr. Donovan stated, “In addition, IMF staff had consistently urged from the beginning of the decade the introduction of a property tax and a reduction in mortgage interest relief to help counter a strong pro-house ownership bias.” Why is the IMF opposed to ordinary Irish people owning their homes as opposed to spending their lives at the mercy of landlords? Dr. Donovan also stated, “The thrust of the staff view was that for most of the 2000 to 2007 period, house prices were somewhat overvalued”. The research available to us shows that from 1996 to 2006 the price of an average home increased each year by the equivalent of the average industrial wage. Is it fair, therefore, to state that they were somewhat overvalued? I do not know of a single instance where an international or a national organisation - such as the IMF, the EU Commission or the Central Bank of Ireland - uttered an expression of concern regarding that young generation of working people who were the victims of the huge inflation in house prices which took place between 1996 and 2006. At that time, the periods of repayment relating to mortgages were extended from 20 years to 40 and lending reached unsustainable levels. Those to whom I refer were the victims of what some people call “overweening profiteering and speculation”. Why was that the case?

**Chairman:** We are in the process of wrapping up proceedings. The Deputy should not seek to revisit these matters in detail.

**Deputy Joe Higgins:** Why did the organisations in question not say anything about the people who are the victims of what happened?

**Dr. Donal Donovan:** I do not think the IMF is in any way opposed to people owning houses. However, in the case of Ireland, there was the taxation system and this encouraged people to engage in widespread house purchases. In turn, this led to individuals buying not just one but a number of houses. As a result of the fact that there was no significant capital gains tax or a property tax and that there was substantial mortgage interest rate relief, relative to other countries - this is all relative - the fiscal structure in Ireland leaned towards and favoured more than the average in the context of the acquisition of houses, including for investment purposes. Eventually, it ended up with people purchasing houses for speculative purposes. That is the point at which the IMF was trying to get.

On the observation with regard to houses being “somewhat overvalued”, I must stress that I am only describing what the IMF said, I am not defending its statement. The IMF was reluctant - as is the case with many other entities - to put a number on how big it believes an overvaluation may be. This is partly because there are dozens of different calculations one can make and people come up with different views. My personal view is that it could have been somewhat more explicit on this matter and might not have used the term “somewhat”. However, that did not prove to be the case. Perhaps that is a legitimate criticism.

With regard to the third observation, the IMF does not attempt to provide views on all aspects of the economy. It is not within the organisation's mandate to do so. However, there is no shortage of institutions, both domestically and externally, that will address issues of equality, poverty, the inability of people to buy homes and so on. It is not that the people who work for the IMF, as individuals, do not view this as a bad situation, it is because it is just not part of the organisation's mandate to address specific issues of inequality and difficulties relating to access.

**Deputy Kieran O'Donnell:** In the book on the late Brian Lenihan, Dr. Donovan referred to Professor Honohan. If Timothy Geithner had not objected to the burning of bondholders, would Europe have proceeded to burn them and would this have been of benefit to Ireland?

**Chairman:** That calls for speculation.

**Deputy Kieran O'Donnell:** I was quoting directly from the book.

**Dr. Donal Donovan:** We know the ECB was strongly opposed and it would remain opposed. Let us suppose Mr. Geithner had not intervened. If the IMF had come strongly to the view that the burning of some bondholders would have been desirable and necessary - I have no sense what the EU Commission thought about this issue at the time - something might well have happened. However, I return to what I said earlier. The importance of this issue can be exaggerated in numerical terms. We seem to be talking about the potential for burning bondholders and thereby saving approximately €6 billion for the Irish taxpayer. That is in no way a trivial amount but it is not €64 billion.

**Deputy Kieran O'Donnell:** The report which Dr. Donovan was involved in compiling references Professor Honohan. The latter appeared before the inquiry recently and expressed the view that the possibility of allowing Anglo to fail should have been considered. Is Dr. Donovan of the view that the Financial Regulator and the authorities should have been aware that Anglo was insolvent on the night the guarantee was introduced?

**Chairman:** Sorry, but that is a leading question.

**Deputy Kieran O'Donnell:** In Dr. Donovan's view - knowing all the facts - would it have been reasonable for the authorities to have been aware that Anglo was insolvent on the night the guarantee was introduced?

**Chairman:** Let me forewarn Dr. Donovan that he can answer questions that are within his competence, knowledge and his sphere of expertise on which he can speak authoritatively. I am interested in evidence not opinions. We can have a cup of coffee later to discuss opinions.

**Deputy Kieran O'Donnell:** Dr. Donovan indicated that he felt Anglo Irish Bank should not have been allowed to fail and he referenced the report of Professor Honohan and his team, of which he was a member. Professor Honohan has subsequently come before this committee and has stated that in his view, there should have been strong consideration of allowing Anglo Irish Bank to fail.

**Chairman:** If the Deputy is going to quote Professor Honohan -----

**Deputy Kieran O'Donnell:** He said his view was -----

**Chairman:** Will Deputy O'Donnell give me a moment? If members are to cite what witnesses have said, I would advise them to have the transcript in front of them.

**Deputy Kieran O'Donnell:** Let me put it another way, Professor Honohan said allowing Anglo Irish Bank to fail should have been considered in the context of discussions with Europe and it would have effectively been delayed for a week, in terms of ELF funding being provided to Anglo Irish Bank. My question is whether Dr. Donovan believes on the night of the guarantee it would have been reasonable that the authorities should have been aware that Anglo Irish Bank was insolvent at that time.

**Chairman:** That is the same question.

**Dr. Donal Donovan:** There are two distinct scenarios and I believe Professor Honohan has clarified this.

**Chairman:** He has and let me put on record that Professor Honohan has corresponded with the committee on the subject of his earlier engagement with us, where he added further information to his presentation. That is why in this regard I am very explicit and clear with regard to members drawing from witnesses' contributions.

I ask Dr. Donovan to be very measured.

**Dr. Donal Donovan:** If I may, using that framework, outline the scenarios. First, if they had known that Anglo Irish Bank was insolvent, then the question would have been what to do. I understand there is a view that it should have been liquidated overnight. That would have, however, led to the kinds of costs associated with the closure of Anglo Irish Bank that the Honohan report describes at some length. Whether those costs which he describes very vividly and to my knowledge he has not changed his view, would have been greater than the costs up to €64 billion or a figure ranging from €40 billion or some other number, who knows.

The second scenario is completely different and distinct and is the one that Anglo Irish Bank had, a liquidity problem. Should they have gone for emergency liquidity assistance, ELA, and hoped that something would work out at the end of the week? This is discussed quite a bit in our book. One never knows what would have happened. Would a solution have been found? In my view for what it is worth, I do not see a strong reason to believe that the European position on the Thursday before 29 September would have been radically different one week later. Others may disagree. What would have changed? We had no new information on the bank's situation. We were still thinking that it was illiquid but not insolvent. We never found that out until six months later. What would have happened in a week for the Europeans to say, "Okay, on second thoughts go ahead and liquidate Anglo Irish Bank and do something different". That is where I have a problem with the idea that waiting a week would have changed matters.

**Chairman:** We are moving into the realms of speculation. Dr. Donovan was not directly involved in those circumstances?

**Dr. Donal Donovan:** No.

**Chairman:** On that basis I will bring his contribution to a conclusion. I thank Dr. Donovan for his participation in today's meeting. It has been very informative and valuable and has added to our understanding of the factors leading to the banking crisis. We have exceeded the time Dr. Donovan had planned to be before the committee and I acknowledge that his prior engagements may now be disrupted. As another meeting will take place in this room shortly, I propose we adjourn until tomorrow.

The joint committee adjourned at 2.45 p.m. until 9.30 a.m. on Wednesday, 25 February 2015.