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AN COMHCHOISTE FIOSRÚCHÁIN I DTAOBH NA GÉARCHÉIME BAINCÉI-REACHTA

JOINT COMMITTEE OF INQUIRY INTO THE BANKING CRISIS

Déardaoin, 26 Feabhra 2015

Thursday, 26 February 2015

The Committee met at 9 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.

Mr. David McWilliams: While we all get lots of things wrong, I do not think I got anything wrong during the period we are discussing. I am an economic commentator. I am an independent economist and have never been paid by the State for advice.

Chairman: I had many professions before I came here and I have got things wrong in those professions. It is not just politics.

Mr. David McWilliams: Of course one gets things wrong.

Chairman: Give us an example of something you got wrong in 1.2 million words.

Mr. David McWilliams: I get things wrong every day.

Chairman: Give us an example. In the 1.2 million words you have written about the economic crisis in this country, did you get anything wrong?

Mr. David McWilliams: It is an unfair question. One gets things wrong every day and one hopes to learn from them.

Chairman: In terms of getting things right for the future, what is your assessment of the Irish Government's level of preparation for the banking problems that emerged in September 2008? How well was the State prepared? Are Irish policy making authorities better prepared today, particularly regarding the regulation of the property and banking sectors?

Mr. David McWilliams: We were totally unprepared in 2008 because we had not listened to any of the warnings. I am not sure I see anything now that would prepare us again for such an eventuality. The most important thing is to be hyper vigilant on a sector which, if managed well, can serve the needs of the economy very well but, if managed badly, can lead to a financial catastrophe.

Chairman: Is there anything else you would like to add before we conclude?

Mr. David McWilliams: No.

Chairman: I thank Mr. McWilliams for his participation today. It has been a very informative and valuable meeting which has added to our understanding of the factors.

Sitting suspended at noon and resumed at 12.15 p.m.

Professor Terrence McDonough

Chairman: I welcome Professor Terrence McDonough and apologise for the late commencement of session B, which is to discuss issues relating to the international, EU and domestic policy contexts to the banking crisis in Ireland. Professor McDonough is professor of economics at NUI Galway and has a PhD in economics from the University of Massachusetts at Amherst. Before joining NUI Galway in 1995, he held posts at the Institute of Industry Studies at Cornell University, Canisius College, Buffalo, and Dublin City University. He has published numerous books and academic articles, was on the editorial board of the Review of Radical Political Economics and is currently on the editorial board of the International Journal of Pluralism and Economics Education. His current interests include globalisation, American and Irish economic history, political economy, the history of economic thought, and economics education for labour and community groups.

Before we begin, I advise Professor McDonough 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. They are directed that only evidence connected with the subject matter of these proceedings is to be given and, as they were previously informed, the committee is asking witnesses to refrain from discussing named individuals in this phase of the inquiry.

Members are reminded of the long-standing parliamentary practice to the effect that they 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 Professor McDonough to make his opening statement.

Professor Terrence McDonough: I thank the committee for inviting me to testify before it today. Along with the rest of the nation, I am looking forward to learning about many of the specific events and decisions leading up to the Irish banking crisis. In contrast, however, I will concentrate on addressing today's brief, which concerns the international, European and Irish policy context of the banking crisis. In doing so, I will be presenting a macroeconomic analysis of the overall crisis which still faces the world's peoples today, at least seven years after its inauguration.

It is important to understand that the situation affecting Ireland at the time of the banking guarantee cannot be characterised only as a financial crisis. Instead, Ireland at this time was caught up in a perfect storm, one whose great winds have periodically abated only to blow up again. It is popular in some quarters to refer to Ireland's crisis as homegrown, and it is certainly true that one storm front blew up within the borders of Ireland. However, 2008 saw the tragic convergence of this front with two other influences, one the global storm of the international crisis of global neoliberalism. This blew Ireland against the other influence, namely, the unforgiving shores of the euro system. We do not have to go all the way back to the proverbial butterfly flapping its wings to find the origins of this maelstrom. The global crisis, the European crisis and the Irish crisis all find their origins in the same basic institutions of the age. All are rooted in the four institutions of globalisation, neoliberalism, repression of labour and financialisation.

What are these institutions? Globalisation is the disintegration of production processes into their component parts and the location of each of these components in that area of the world most congenial to making profits. The production process is then reintegrated through free trade across borders. This process brings employers and workers face to face across the globe. Neoliberalism is a complex phenomenon. It can perhaps be most succinctly described as market fundamentalism, a belief that important social decisions about production and income distribution are almost always and everywhere best left to be determined in markets. This idea manifests itself in institutions like the World Trade Organisation, policies like deregulation and privatisation and ideologies like free market economics. The repression of labour involves the erosion of the power of labour to defend its organisations, working conditions and standard of living. It is most dramatically evidenced in the decline in union density. Financialisation, according to the American economist Jerry Epstein, "refers to the increasing importance of financial markets, financial motives, financial institutions, and financial elites in the operation of the economy and its governing institutions, both at the national and international level".

All these institutions date from the early 1980s. Their beginnings are marked by the political victories of Ronald Reagan in the United States and Margaret Thatcher in the United Kingdom. These new institutions can be collectively labelled the era of global neoliberalism. This new stage of capitalism at first led to recovery. In the 1970s, capitalism was in a period which has come to be known as the Great Stagflation, a condition of simultaneous high unemployment and high inflation which was unpredicted by the Keynesian economics of the time. Together, globalisation, financialisation, neoliberalism and the loss of labour influence led to a period known in some quarters as the Great Moderation. Profit rates, which had been falling from the late 1960s, bottomed out in the early 1980s and over time returned to their previous levels. Growth recovered, although it did not reach the standards of the earlier post-Second World War period. Employment rose and inflation fell and remained low.

However, this economic recovery is only one side of the story. The same set of institutions which led to the global neoliberal recovery from stagflation would eventually create the most serious economic crisis since the Great Depression. Problems became evident almost immediately. Globalisation led to the unification of previously separate national markets for goods and services. Competition within this new larger market led to the emergence of excess capacity in many industries. Labour's loss of bargaining power led to the stagnation of real median family income in the United States. This wage stagnation occurred despite the continual increase in the productive capacity of labour. These two factors, excess capacity and stagnant wages, led to a rate of investment which, while positive, was relatively sluggish by historical standards. This relatively sluggish investment was accompanied by restored profitability. If the restored profits were not being invested in productive plant and equipment, where could they go? Financialisation made it increasingly easy to fund the purchase of various categories of assets, driving up their prices and creating capital gains, which could only encourage further speculation in asset prices. Borrowing on the basis of rising asset prices temporarily sustained demand in the face of sluggish investment and stagnant wages. When the asset bubble burst, however, the full force of listless investment and low wages was felt in the emergence of what was, in Keynesian terms, a crisis of inadequate demand. For the ordinary household, it was a crisis of unemployment.

That is the global context and, naturally, we are much more concerned with the specific situation of Ireland. A close look at the origins of the Celtic tiger, however, reveals that it was a creature of these same four institutions of global neoliberalism, namely, globalisation, neoliberalism, the repression of labour and financialisation. As is often the case in Ireland, we had to wait a few years for the advent of global neoliberalism - Irish style. For Ireland, the key date is 1987. A neoliberal approach to government in Ireland began when a minority Fianna Fáil Government came to power in 1987. Minority status led to seeking a consensus economic strategy which could attract the support of other parties. It was supported by Fine Gael's adoption of the Tallaght strategy under the leadership of Alan Dukes. Two years later the neoliberal Progressive Democrats entered coalition with Fianna Fáil. O'Riain and O'Connell summarise the turnaround in public spending:

> Restoring order to the public finances was achieved by severe cutbacks in public expenditure in 1987-1990. Total current spending fell by over ten percentage points in real terms between 1987 and 1989. Total current spending fell from 57% of gross national product in 1985 to 42% in 1990.

The fall in expenditure created room for tax cuts. The top rate of income tax fell from 60% to 48% over five years. Basic corporate income tax rates also fell.

In addition to embarking on a new macroeconomic strategy, the new Fianna Fáil Government also convened the first of a series of tripartite industrial negotiations leading to a national partnership agreement, the Programme for National Recovery, PNR. For the unions' part, they could sense a rightward shift in the political system and feared the Government might be capable of importing the Thatcherite strategy of a massive attack on the unions aimed at negating their economic, social and political influence. The PNR established a neoliberal pattern of achieving wage moderation through the promise of future tax cuts. Frank Barry calculates these tax cuts accounted for about one third of the increases in take-home pay to 2004. Such moderation under social partnership led to a falling wage share. The wage share was 71 % of gross domestic product in 1986 and fell to 54% in 2001. Days lost through industrial disputes dropped off drastically beginning in 1987. Accordingly, the repression of labour in Ireland led not to wage stagnation, as in the United States, but to wage moderation under social partnership.

The social partnership process was careful not to jeopardise Ireland's traditional internationalisation strategy. Teague and Donaghey conclude that social partnership operated "hand-in-glove with the wider policy of economic openness". The Single European Act came into effect in 1987 and was approved by referendum in the same year. The implementation of the Single Market coincides with a boom in foreign employment in Ireland, with such jobs growing by 50% between 1987 and 2000. The Single European Act was accompanied by plans to expand Structural Funds spending. Structural Funds were doubled in 1988 and again in 1993. A new Industrial Development Agency, IDA, strategic plan was unveiled in 1983. The new strategy would concentrate on technologically advanced firms with high potential for market growth. These developments copperfastened globalisation as an essential element of Ireland's growth strategy.

The year 1987 also saw the investment hunting capacity of the IDA applied in a new realm. It was decided by the incoming Government to target investment in international financial services through the establishment of the International Financial Services Centre, IFSC. By 1999, attracted by light touch regulation, 66% of all FDI, foreign direct investment, inflows were accounted for by the IFSC. It was the source of 24% of all services exports. The IFSC would be an important conduit for foreign capital flows and was central to Ireland's participation in transnational financialisation.

Irish participation in the global neoliberal social order was no longer in doubt and this institutional framework underpinned the advent of the famous Celtic tiger. Of course, the tiger is also now infamous because, as was the case at the global level, the elements of global neoliberalism would not only set the conditions for Ireland's rise but also its spectacular fall from grace. Under Ireland's peculiar labour institutions, wages rose but the level of inequality rose much faster. The fear of Thatcherism had fed into the formation of social partnership. As noted before, wage moderation was traded for tax cuts. This tendency was strongly reinforced by the perceived need to compete globally through low taxes and a neoliberal policy preference for minimising the capacity of the State.

The economic momentum of the Celtic tiger eventually fed into blowing up the real estate market. Financialisation provided the wind beneath the wings of the Irish asset bubble. Rising levels of inequality created an aspiration for levels of consumption which for many could not be supported from current income. Rising house prices provided an expensive asset of expanding value for those in the housing market and collateral for borrowing by those who already owned their own homes. Household debt rose from less than 120% of disposable income in 2003 to 220% in 2009. The bubble in the property market provided an alternative source of government income through stamp duty and construction-related VAT, compensating to some extent for the overall low tax regime.

Ireland was now poised for crisis. We had a property bubble which could be traced back to financialisation. We had high levels of household debt which could be traced to the property bubble and rising inequality. We had a low tax regime which could be traced back to the repression of labour, globalisation and neoliberalism. The property bubble burst in 2007, endangering the banking system. The global crisis hit in 2008, intensifying Irish problems. The collapse of banking, construction and the tax regime produced a fiscal crisis. The financial crisis, the fiscal crisis and unsustainable household debt then created an unemployment crisis. It was at this point that the global storm front and the Irish turbulence combined ran up against the sea cliffs of the inflexible euro system. This euro system was also rooted in global neoliberalism, a global neoliberalism - euro style. The drive for globalisation led to the Single European Market. Globalisation linked with financialisation to create the euro currency. The Single European Market and the euro led to trade surpluses in some countries that were recycled into blowing up asset bubbles and trade deficits in other countries which weakened their fiscal positions. Financialisation, linked with a strong dose of neoliberal ideology, led to a fiercely independent European Central Bank aggressively limiting its responsibility to inflation control. Neoliberal ideas of small government and limited intervention in private markets, with the declining influence of labour, led to a monetary union without any fiscal capacity to address problems through increased government spending at European level. Together the Single European Market, the euro, the European Central Bank and limited fiscal capacity can be said to constitute the euro system.

When the turbulence hit, the euro system made sure Ireland could find no haven through devaluing its currency, conducting an independent monetary policy or receive help through fiscal stimulus. The euro rules have forced Ireland to cut spending and raise taxes in the teeth of a depression. Instead of a port in the storm, the backwash from the euro cliff intensified the maelstrom. On 29 September 2008, in the dead of night, Ireland desperately tried to signal for help, but the cannon broke loose and holed the ship of State below the waterline.

How could this catastrophe have been avoided? The only path was to have seen the storm coming and been prepared for it. This is not a question, as some have recommended, of hiring more economists in the Department of Finance. In fact, professional politicians and professional economists in the lead up to these events all saw the world in much the same way. To avoid the storm, both would have had to see the world differently. I have lived for 20 years in Galway. It is said of the weather in Galway that it is either raining or about to rain. Similarly, in the mainstream economic view, the economy is either calm or rapidly becoming calmer. This theory may barely pass muster in good times, but to prepare for a storm you have to see the economy as potentially tempestuous and riven with conflict and contradictions. A view of the capitalist economy which ignores its historical dynamics, which sees it as a haven of harmonious give and take, a peaceful equilibrium of supply and demand, which works best when interfered with least, will inevitably lead to foundering on hidden shoals amidst unexpected turbulence. This is where Ireland still finds itself today.

Chairman: Thank you Professor McDonough. In your opening statement you make strong reference to a neoliberal policy programme that has been in place since 1987 up to the present. Can you define what you mean by neoliberalism?

Professor Terrence McDonough: It would probably be helpful to talk more specifically about what would constitute neoliberal policies which persisted pretty much from the 1987 breaking point up to the current day. The first point is the relatively low level that public expenditure takes up in relation to Irish GDP. This is somewhere around 30%, whereas the EU average would be around 40%. This has been consistent throughout this entire period. It is similar to the situation of the tax take, which came down subsequent to 1987 and has not come back much.

The question of openness and free trade and the strategy of internationalisation and running export surpluses would be very consistent across all the governments, in this case since 1957, certainly from 1987 to the present. We have also engaged in very light touch regulation which has persisted since 1987 and the foundation of the Irish Financial Services Centre, IFSC. While these policies might not have been defended enthusiastically by any given Administration they have remained constant.

Chairman: I am sure you will be familiar with the budgetary process, that education, social welfare and health costs as a proportion of the budget make up the lion's share of the overall sum. Would you see that level of expenditure in the annual budget as consistent with the theory you are proposing?

Professor Terrence McDonough: Yes I would in the sense that neoliberalism is always relative. It is relative to the levels of expenditure which would have been achieved under other policy regimes. While those levels of expenditure are substantial and not negligible they would be smaller than those of our European partners. They compare favourably with those in the United States and Britain but those countries would be examples of heavily neoliberal influenced regimes.

Senator Michael D'Arcy: I welcome Professor McDonough and thank him for coming here. He states:

> The global crisis, the European crisis, and the Irish crisis all find their origins in the same basic institutions of the age. All are rooted in the four institutions of globalisation, neoliberalism, repression of labour, and yes, financialisation.

Which of these does he believe was the most important in causing the Irish banking crisis?

Professor Terrence McDonough: The Irish banking crisis can be most easily traced to a combination of financialisation on the one hand and neo-liberalism on the other. The linking of Ireland to the global financial markets was extraordinarily strong. There was quite a bit of money available which consequently was brought into the country and transferred to domestic activity. The low level of regulation and the high level of openness to financial movements would probably be where I would lay the most emphasis. This is also closely related to the whole goal of globalisation and the establishment of the IFSC was part of our globalisation strategy.

Senator Michael D'Arcy: Professor McDonough also states, "A neoliberal approach to government in Ireland began when a minority Fianna Fáil government came to power in 1987". Could he name non neoliberal Governments prior to 1987?

Professor Terrence McDonough: Yes, I certainly think the Administrations immediately previous to that one would not be considered neoliberal in that they had very high levels of expenditure and were associated with high levels of tax. The tax levels were not high enough to cover the expenditure. Previous to 1987 the Irish regime was a more typically Keynesian one rather than a neoliberal one. That would be true across the board in North America and Europe as well.

Senator Michael D'Arcy: What about the Fine Gael-Labour coalition Government prior to 1987?

Professor Terrence McDonough: It would not be considered neoliberal.

Senator Michael D'Arcy: What about the Fianna Fáil Government under Charlie Haughey immediately prior to that?

Professor Terrence McDonough: Charlie Haughey has prominence in having led the most non neoliberal and then the most neoliberal governments.

Chairman: Professor McDonough should speak of the Administrations rather than the individuals.

Professor Terrence McDonough: I am sorry, I did not mean to single anyone out.

Senator Michael D'Arcy: Would Professor MdDonough describe most of the Governments since 1987 as neoliberal?

Professor Terrence McDonough: Yes, to differing degrees but neoliberalism is a set of policies and preconceptions, tendencies etc., all of which can be said to have played a role to a greater or lesser degree in each of the Administrations since 1987. This would also be true in Great Britain on one side of our country and the United States on the other. There were transitions between Democratic and Republican Administrations in the United States but the basic orientation of each Administration, when considered at this abstract level, was the same.

Senator Michael D'Arcy: Is that irrespective of which party was in government?

Professor Terrence McDonough: Irrespective of which party. The Blair regime in the UK could also be characterised as a neoliberal regime.

Senator Michael D'Arcy: How did neoliberalism and globalisation affect the Irish bank guarantee?

Professor Terrence McDonough: The neo-liberal approach sees the economy as fundamentally sound, with basically free markets. If you see the economy as fundamentally sound and you have basically free markets you have a theory called the efficient markets hypothesis. It argues that markets consistently use the maximum amount of the best information to come to valuations which reflect the best information at the time. This could therefore always be trusted to form the basis of further action. Governments could not really compete with markets in gathering this information and felt themselves to be at a disadvantage. Governments felt the best thing to do was reinforce wherever the markets were going.

When the banks came to the Government and explained they did not have a solvency crisis but simply a temporary liquidity crisis which could be addressed through a guarantee to get over the hump, I believe the Government can be partially forgiven for believing this. Not because it was correct, clearly it was not, but that was the conventional wisdom of the time. The conventional wisdom of the time led us to the depressed situation still facing us today. The conventional wisdom of the time needs not to be reinstated but broken with.

Senator Michael D'Arcy: In his opening address, Professor McDonough states, "Ireland at this time was caught up in a perfect storm, one whose great winds have periodically abated only to blow up again". What period is he talking about, this era of the perfect storm?

Professor Terrence McDonough: I believe that storm begins in 2007 but is not quite evident until 2008. I believe we are still in it now. So, from 2008 until the present.

Senator Michael D'Arcy: Can I ask the witness what, in his opinion, are the ingredients of the perfect financial storm?

Professor Terrence McDonough: I believe the ingredients of the perfect storm are not simply limited to financial questions. This is one of the larger points I want to make in the context of this hearing today. While there is much emphasis placed on the financial troubles that faced Ireland, Europe and the larger global capitalist system, this should not blind us to the fact that there were other deeply rooted institutional factors. These factors contributed to the inauguration of the crisis in 2008, but also seriously contributed to the failure to address that crisis in subsequent years. These factors particularly relate to stagnant wages; the falling power of labour to defend its working conditions; low levels of investment closely related to high levels of excess capacity associated with globalisation on international markets; the inability of governments at local Irish level, at larger European level and at the global level to find a way to intervene to compensate for the financial chaos we faced; very low levels of private investment and the increasing inability of the ordinary person to prop up consumption in the economy because of falling wages and falling standards of living.

The crisis is broad but at the same time much deeper. It goes to the basic institutions of the era in which my students have grown up, which began in 1987 in the international context and in subsequent years in the Irish context.

Senator Michael D'Arcy: The era of stagnant wages was mentioned as from 2007 until now, is this correct?

Professor Terrence McDonough: I should make the distinction that I am talking about stagnant wages in the global context. The Irish context did not experience wage stagnation to the same degree, in fact Irish wages and income probably doubled in the period between 1987 and 2005.

Senator Michael D'Arcy: Regarding the low interest rates from the crisis era, would they have contributed?

Professor Terrence McDonough: Certainly the low interest rates did contribute to the problem. These are probably often dropped out of explicit consideration because interest rates in the European single currency market are determined by European policy. The interest rates were probably much more suited to Germany which was trying to come to terms with the reunification with East Germany and the economic problems created by that. The rates were certainly inappropriate to an Irish economy facing in to a serious housing bubble.

Senator Michael D'Arcy: Professor McDonough states that we had a low-tax regime traceable to the repression of labour globalisation and neoliberalism. The property bubble burst in 2007. Did we have a low tax regime or did we have a too narrow tax base?

Professor Terrence McDonough: That is a good question. I believe both are true. On the one hand we had a set of social partnership agreements which were trading wage moderation for cuts in income tax. I believe that resulted, along with our internationalisation strategy, in tax rates which were lower than they should have been. They were certainly lower than comparable continental countries. The Government was also making up for these low income tax rates by taxing the property bubble in various ways. Taxing a property bubble is a way of narrowing the tax base because a property bubble cannot continue forever.

Senator Michael D'Arcy: Can I ask the professor his view on taxation. He says that the tax base was reduced from 60% to 48% and subsequently the marginal rate is now 40%. Does he think we should go back to the 60% rate? I would also like his opinion about the establishment of the International Financial Services Centre which many consider a success story. I refer to the film "The Commitments" which was my memory of the docks in the early 1990s.

Professor Terrence McDonough: The artistic reference is interesting. In *The Irish Times* this morning, Yanis Varoufakis, the Greek finance Minister, makes reference to Beckett's play, "Happy Days". If the question is posed on whether we wanted a derelict dockland or an Irish financial services centre one can certainly see the argument for establishing the IFSC. The point I keep coming back to is that all of these things have their impact and work their impact out in a dynamic way over the course of time and that things which are initially positive in their impact can ultimately contribute to very serious negative outcomes as that dynamic works itself out.

The establishment of economic activity in the Dublin docklands was a very good thing. The total lack of regulation of that economic activity, especially in light of its financial character, turned out to be not such a good thing and the impact of that on the remaining portion of that neighbourhood in the docklands now is substantially negative.

As regards the tax question, I think that we can do with higher tax rates on upper income levels; we can do with taxing wealth in addition to income; we can do with a policy which raises the incomes of people at the lower end of the economic scale and which then provides an opportunity to increase taxation there as well.

I am not a supporter of this process whereby more and more people are taken completely out of the tax net and are then no longer seen as contributing to the collective services which the society should be providing, primarily for people at the lower end of the scale. I think we need to collect more taxes in general.

Deputy Michael McGrath: Professor McDonough is very welcome. Are we pronouncing your name right?

Professor Terrence McDonough: Yes.

Deputy Michael McGrath: Very good. I thank him for his attendance and participation. I will start by maybe developing a better understanding of his economic outlook and philosophy, which is shaping his opinions, and will put a few questions to him in that context. He referred to the Single European Market. Is he in favour of the Single European Market and of the European Union project, for example? Could he give us his view on that?

Professor Terrence McDonough: That is an excellent question and a difficult one. In general, I would have been quite sympathetic to a process of political unification across Europe but I would have always been supportive of basing that process of political unification, at the very minimum, on traditional European social democratic values. I think that in the current period, especially in terms of the negotiations which have taken place between the Greek Government and the European Union institutions over the past two weeks, a line has been drawn under the traditional social Europe model. What has developed in the era of monetary union is very difficult to defend not only philosophically, but also economically.

Basically taking exchange rate policy out of the hands of local governments has proven to be extraordinarily damaging. The separation of local governments from the ability to conduct their own monitoring policy has been extraordinarily damaging. Setting governments in competition with one another within the EU around the questions of tax policy and expenditure, without creating a more federal capacity to spend and address problems when they arise, has been extraordinarily problematic. I think a militantly independent central bank, insulated from democratic control, is not defensible.

Beyond that, the European Union has unfortunately participated in a general tendency to separate economic decision-making from democratic and representative bodies and rest that decision-making in what were initially faceless bureaucracies but they have now, more or less, acquired a bit of a face. We can now talk about these personalities. People know who Wolfgang Schäuble and Mario Draghi are but that is problematic in itself. These people should not be as important as they are and I think that calls, as Michael Noonan would have said, the practice of the European-----

Deputy Michael McGrath: To move on, Professor McDonough has spoken somewhat positively about the notion of political integration and political unity but what I am hearing from him on all of the other economic pillars and on the monetary union is negative. Is he in favour of free trade within the European Union and the free movement of people and, for example, of capital pillars of the European projects?

Professor Terrence McDonough: What has happened in terms of the free movement of capital relative, to some extent, to the free movement of labour, is that one of the sources of the problems which I identified, which is wage stagnation in much of the world and increasing inequality in this corner of the world, particularly, has been the radical change in the bargaining power of capital relative to labour and the free movement of capital is the conditioning of that-----

Deputy Michael McGrath: They are not very clear answers. I am getting an analysis but not any answers.

Professor Terrence McDonough: I am not an enthusiast of the free movement of capital but on the other hand I am not an enthusiast in trying to prevent the free movement of labour.

Deputy Michael McGrath: It is kind of on the one hand and on the other hand. Is Professor McDonough in favour of the euro?

Professor Terrence McDonough: I have to say that at the moment, I am not. There are two different questions. Was the euro a good idea? Absolutely not. Is it extraordinarily difficult to think about how one might approach that and move to the other side of the problems which that has created, that is, should we leave the euro? We need to be thinking about that. I would not say we should leave the euro as definitively as I would say that entering the euro was a mistake.

Deputy Michael McGrath: Is there an economy somewhere on the globe that the professor would hold out as the role model?

Professor Terrence McDonough: No. I think what Ireland needs to do is find a way to build the society it wants to be and then find a way to put that society before the world and invite participation from other countries, corporations and things like that.

Deputy Michael McGrath: Is Professor McDonough prepared to name a country that comes closest to his ideology in terms of an economic model?

Professor Terrence McDonough: No.

Deputy Michael McGrath: Is there any?

Professor Terrence McDonough: No.

Deputy Michael McGrath: On the issue of the nexus of the four institutions to which the professor referred - Senator D'Arcy took him through a number of those - could better regulation domestically by the Irish Central Bank and the Irish Financial Regulator have been an effective counterweight to the nexus of those four institutions? Could proper and effective regulation in his view have offset what he might regard as the negatives from these four institutions?

Professor Terrence McDonough: I think proper and effective regulation would have gone some way to preventing the problems we were in. The 40 pieces of legislation which were passed over the period of time from 1987 to the early 2000s, basically the liberalising of the financial markets and making it easier to engage in these kinds of activities, were quite clearly a mistake.

Deputy Michael McGrath: Professor McDonough identified a point in our economic history and political history, 1987, as somewhat of a turning point, in his view, when these types of policies began to be pursued. Is he, therefore, of the opinion that what went immediately prior to that was better and more sustainable from an economic point of view?

Professor Terrence McDonough: Clearly not. Ireland was very much in crisis in 1980, in 1985 and in the late 1970s. I would not put the Irish crisis in the 1980s as the model for dealing with the Irish crisis in the 2000s.

Deputy Michael McGrath: As for one to be holding out 1987 as a negative turning point, many commentators would argue it was a positive turning point in dealing with the crisis we had, would Professor McDonough give us his view?

Professor Terrence McDonough: It is certainly true that we did deal with the crisis we had. As primarily an economic historian, my work has been involved with observing that the resolution to one crisis is often, as history unfolds, the basis for the outbreak of the next. That is very much what happened in Ireland. We resolved the 1980s crisis in a certain way and the way in which we resolved it formed the basis for continuing social change and continuing social struggle. The upshot of those very institutions which resolved the crisis was ultimately, many years later, to set the stage for the crisis we face today. That is one of the contradictions of history.

Deputy Michael McGrath: One of the four institutions, the primary drivers of the economic model, Professor McDonough cites is what he terms "the repression of labour", which, he states, "involves the erosion of the power of labour to defend its organizations, its working conditions and its standard of living". I am curious as to how he can reconcile that with his criticism of the social partnership agreements, which, many would argue, gave the labour movement far greater power and greater influence in the running of the country. Can Professor McDonough reconcile those two points?

Professor Terrence McDonough: We could probably deal with this fundamentally by looking at the outcome in terms of labour's share in national income. I suppose what we could do is contrast it, on the one hand, with the fact that Irish wages did not stagnate in the same way that they did in the United States. On the other hand, if one looks at labour's share of national income, labour's share of national income around 1980 was about 71%, that is, of everything produced in Ireland, 71% of it went to the working class or those represented by the labour movement. By 2002, that figure was down to around 45%. While labour succeeded in preventing an outright stagnation of wages, labour's relative weight in the economy, especially in terms of its income, declined quite drastically. If one looks at labour density, that is, what percentage of the workforce is represented by unions, that dropped rather precipitously. It has been halved, essentially, over the course of social partnership.

Deputy Michael McGrath: In page 9 of his opening remarks, Professor McDonough states:

> Instead of a port in the storm, the backwash from the Eurocliff intensified the maelstrom. On the 29th of September, 2008, in the dead of night, Ireland desperately tried to signal for help, but the canon broke loose and holed the ship of state below the waterline.

Can he elaborate on what he means by "Ireland desperately tried to signal for help"?

Professor Terrence McDonough: To some extent there I am getting caught up in my metaphors. The metaphor is appropriate in that the bank guarantee was intended to be a signal to the private financial markets that they could safely continue to invest in, lend to and capitalise the Irish banking system. In that sense, basically, it was a call for private financial help.

Deputy Michael McGrath: Was Professor McDonough referring to any efforts on the part of the Government or the authorities to reach out internationally in those critical 24 hours or whatever?

Professor Terrence McDonough: No. That was reaching out to the private markets. In fact, I am sure Deputy Michael McGrath will be aware our European partners were initially rather unhappy with it.

Deputy Michael McGrath: Okay. I will leave it at that.

Chairman: Senator Sean Barrett has six minutes.

Senator Sean D. Barrett: I welcome Professor McDonough. This is the third member of the Galway troika. Professor John McHale comes in quite a lot and Professor Alan Ahearne does as well.

Professor McDonough, on page 8, states, "This is not a question, as some have recommended, of hiring more economists in the Department of Finance". What did he mean by that?

Professor Terrence McDonough: I was particularly struck by that recommendation and the promulgation of the statistic that among the employees of the Department of Finance, only 17% have economics degrees. If one were to go back to some earlier testimony, that of Professor John FitzGerald from the ESRI and Dr. Donal Donovan from the IMF, one would discover that it was not the lack of economists in the IMF which caused the failure to call the crisis in a sense in that there is no shortage of economists in the ESRI-----

Senator Sean D. Barrett: It was not the IMF, but the Department of Finance, about which Professor McDonough wrote.

Professor Terrence McDonough: My point is simply there is no shortage of economists in the IMF and those economists were describing the Irish situation as "rosy". If the Department of Finance were to hire the same economists that the IMF did, they would have been telling the same story.

Senator Sean D. Barrett: The IMF only paid flying visits. I refer to the staff who were there all the time in the Department of Finance. The evidence we heard from Mr. Wright was that they represented 7% of the total staff complement in the core of Finance, compared to 60% in Canada and 40% in the Netherlands. Why would Professor McDonough keep it at 7%?

Professor Terrence McDonough: I certainly would not want to be accused of damaging the employment prospects of members of my profession at the Department of Finance or, for that matter, my graduate students. My contention is simply that the economics profession, as it is currently constituted, works with models of the economy which are closed, that is, they assume a closed system. It is a bit like pouring water into a bowl. What happens to the water in the bowl? It reaches its own level and is, thereafter, calm. If one disturbs it, it returns to its previous level. It is not a very good basis for talking about the real world, which is an open system in which water is subject to tides, wind, waves and, occasionally, the mother of all storms. If that is one's model, one will not predict a storm.

Senator Sean D. Barrett: If one retains the number of qualified economists at only 7%, would that not lead to the professor's other problem of light-touch regulation? If one is to regulate a sector, one had better have qualified staff there to do it.

Professor Terrence McDonough: I will take that comment on board, yes. If we were to increase regulation, one would have to increase the expertise of Departments such as the Department of Finance.

Senator Sean D. Barrett: We had the large capital inflow that Professor McDonough criticised earlier. It happened. One was outvoted, if one had wanted not to join the euro. What would Professor McDonough have done, if he were the Governor of the Central Bank and he saw this significant capital inflow coming into Ireland in 2003? How would he have responded?

Professor Terrence McDonough: That is an interesting question. I would certainly have prevented it from all flowing into the housing market and at the cost of having it flow elsewhere. Certainly, high levels of capital inflow that would have been invested in increasing productive capacity in the Irish economy would have been more than welcome. High levels of capital inflow, that perhaps flowed back out again and could be to some extent taxed along the way, would have been, maybe, not to the benefit of our trading partners but could have been to the benefit of the Irish Exchequer. High levels of capital inflow which then flowed into simply increasing the price of assets, most prominently, commercial and residential property, were not constructive. I think we confused rising asset prices with rising health in the economy.

Senator Sean D. Barrett: How should banks be regulated in that context?

Professor Terrence McDonough: My feeling is that bank regulation cannot be too intrusive. I think the lesson of the banking crisis is that the private banking system cannot be trusted with all that money. My view would be that the financial system, the banking system, should be primarily publicly owned. I was asked earlier whether I would point to a model which I would endorse; I would not point to a whole model but I think that the South Korean public ownership of its financial system is really rather well run.

Senator Sean D. Barrett: In the Irish system what proportion of bank funding does Professor McDonough believe should be in equity?

Professor Terrence McDonough: I think if we had a public banking system that would not arise. I would hesitate to give the Senator a specific figure but given our current banking system unreconstructed, I would double it.

Deputy Eoghan Murphy: Is it Professor McDonough's view that social partnership contributed to or played a role in Ireland's financial crisis?

Professor Terrence McDonough: Yes, specifically the deals that were struck around the question of wage moderation. Again I would emphasise that Irish wages did not stagnate like they did in the United States and to a certain extent in Britain. The wage moderation in exchange for eroding the tax base was a poor decision and it was a poor decision which I believe was reached collectively. There were tripartite negotiations between the representatives of the employers associations, the main union federations, and the Government. I think the Government, the employers, and the unions all participated in that decision and I think we have come to regret it.

Deputy Eoghan Murphy: I got the impression from Professor McDonough's opening statement that he felt that the unions had a choice in engaging in social partnership.

Professor Terrence McDonough: That is something that I think the historians of Irish labour will debate. I think the unions did make a choice and that choice was made in light of what was going on across the water and in light of a fear of Thatcherism.

Deputy Eoghan Murphy: Is Professor McDonough's opinion based on some of the historical work that he has already done?

Professor Terrence McDonough: It is based on some of the historical literature and also some of the personal contact I have had with the labour movement over the years.

Deputy Eoghan Murphy: Could Professor McDonough expand upon the point he made on the lack of democracy in the ECB and central banks generally?

Professor Terrence McDonough: Certainly. This is very much a trend internationally. We have been moving further and further away from democratic influence on economic decisions. The model, in a certain sense, is the independence of the American Federal Reserve. The American Federal Reserve has a double mandate. Its mandate is, on the one hand, to control inflation, but also to address the problems of unemployment when they arise. Our central bank, which is the ECB, is not mandated to address the problem of low levels of economic activity throwing people out of work. It is explicitly left out of its charter. It is solely responsible for maintaining stable prices. In that sense I think we have an ultra-monetarist central bank, much more monetarist than one would find in the United States.

Deputy Eoghan Murphy: Does Professor McDonough regard that as a design flaw?

Professor Terrence McDonough: It is very definitely a design flaw.

Deputy Eoghan Murphy: Does Professor McDonough believe that increased democracy can be brought into a central bank without bringing in political interference?

Professor Terrence McDonough: I would not want to define democracy as political interference. I think that if we were to democratise economic decision-making at that level, that is at the high level of central banking, we would need to reform our democratic institutions all the way down to make sure that what we were seeing was the expression of popular will rather than the interference by politicians or vested interests. That said, I think that the performance of the Central Bank in the absence of political supervision has been extraordinarily poor. There has just been quantitative easing in Ireland seven years after it was first engaged in rather successfully by the Federal Reserve Bank in the United States.

Deputy Eoghan Murphy: Thank you.

Deputy Joe Higgins: Professor McDonough relates the origins of the property bubble and the crash to the four institutions that he outlined - globalisation; neoliberalism; repression of labour, which he explains is a reduction in the bargaining power of workers; and financialisation. He gives his definitions of those. He also refers to falling profitability from the 1960s onwards as a feature of international capitalism at that time. Were these institutions, globalisation, neoliberalism, financialisation and reduction of labour power, instruments that were coincidental at this time or were they designed to restore the profitability of capital internationally?

Professor Terrence McDonough: Where did these institutions come from? In general, these kinds of institutional transformation come from the conflicts and initiatives which break out in the context of the previous crisis. In this case we are talking about the stagflationary crisis which we had here in Ireland in spades but which was also evident across the globe. I think that in a certain sense, and this is not always the case historically, what has to happen for this kind of crisis to be temporarily resolved is either some kind of class compromise, which is how one might characterise the New Deal system after the Second World War in the United States, or there has to be a victory by one side or the other. I think the era of global neoliberalism could be characterised as a victory for capital, as a victory for business, and as a restoration of the profit level on the back of the repression of the other major candidate for income in society.

Deputy Joe Higgins: Professor McDonough provided figures which show that the percentage of GDP that was going to workers fell substantially; is this related?

Professor Terrence McDonough: Yes, I believe that that drop in Ireland was the sharpest drop of anywhere; if profitability is raised, the share of labour in GDP will be lowered.

Deputy Joe Higgins: Professor McDonough cited the American economist, Gerald Epstein, who has examined the increasing importance of financial markets, financial motives, financial institutions and financial elites in the operation of the economy and its governing institutions at national and international levels. Why were there such significant levels of financialisation and such massive funds sloshing around the financial markets rather than those funds going into productive investment, infrastructure and job creation in a context of mass unemployment in many parts of the world?

Professor Terrence McDonough: That is relevant to one of the things I have been emphasising, namely, our current problems are related to what has happened in the financial sector and the financial crash. The other factors have to be taken into account precisely to explain why all of this money has flowed into finance, as opposed to its traditional destination as investments in productive capacity. That is substantially due to the other problems that have been manifest in the global neoliberal era, including the stagnation of demand due to repression of wages. If people cannot buy what is produced, there will not be investment in production. If businesses are not interested in buying investment goods because of excess capacity in global markets, people are not going to produce these goods and what are they going to do instead? They are going to funnel their money into financial instruments and to the extent that the money funnels into financial instruments, the prices rise and it looks like a good deal. Of course, it is not sustainable.

Deputy Joe Higgins: The financial markets as Professor McDonough describes them involve international financial institutions, huge banks and hedge funds. Do financial markets operate as a socially progressive factor, a factor that enhances democracy, a kind of economic dictatorship or one, more or none of the above? He described market fundamentalism as a belief that important social decisions about production and income distribution are almost always and everywhere left to be determined in the markets. Was the bailout of banks and bondholders as seen in Ireland consistent with neoliberalism and, if not, why not?

Chairman: We have to give Professor McDonough time to respond.

Professor Terrence McDonough: Once the economic crisis hit, the question arose of who was going to pay the piper. The decision was made that bondholders were not going to pay and that governments would pay. Ultimately, the taxpayers paid and, as the Deputy pointed out, the majority of taxpayers are ordinary working men and women. The decision on who was going to pay came down on one side of the question or the other.

In regard to the dominance of financial markets, it is true that if one has a capitalist economy one has to start with money. Capitalist profit making starts and ends with money. One starts with a certain amount of money and ends up with more money. The real question is where that additional money comes from. Financial institutions provide the starting money. The problem arises when the financial sector of the economy becomes so large that it interferes with the provision of resources for the real economy. I would not characterise it as a dictatorship of the financial sector. If we were to go back to the last financially dominated post-Second World War social order, we would find that different elite interests exercised influence in the political arena.

Deputy John Paul Phelan: I refer to Deputy Michael McGrath's questions about Professor McDonough's economic thesis. Professor McDonough identified South Korea as an example of a banking sector that worked. There must have been a successful society or country at some stage in history on which he is basing his arguments. Most financial theories are based on an example that worked. I am not asking him to identify one specific society but where is the basis?

Professor Terrence McDonough: If we consider the entirety of my academic work on the current period and the basis for it - I have also done work on the 19th century in Ireland which is less relevant - my concern has been to understand the historic dynamics specifically of capitalist systems. In my work I have identified what I think is a useful characterisation of the long-term dynamics, which is that we have periods of relative calm and relatively successful capitalist growth, during which recessions are shallow and the expansions are long, but we also have periods of capitalist crisis. We can find the periodic arrival of these crises in the revolutions of 1848, the long depression of the late 19th century, the great depression of the 1930s, the great stagflation of the 1970s and, now, the great recession of the early 21st century.

Deputy John Paul Phelan: Does Professor McDonough have examples-----

Professor Terrence McDonough: I am not really that interested in identifying which of those periods in any particular country would be a model for the others. In fact, the conclusion is that when one is faced with a crisis, one must do something different. Do not look for past models.

Deputy John Paul Phelan: That is a fair point. To be clear, I was asking Professor Mc-

Donough whether he could provide examples of where the alternative to the criticisms he made in his presentation actually worked. He has not pointed to any alternative, bar the banking sector in South Korea.

Professor Terrence McDonough: We cannot solve a global neoliberal crisis with more global neoliberalism. Similarly, I do not think we can solve it by looking to the past. We need a creative approach.

Deputy John Paul Phelan: I will ask a completely different question regarding the Irish crisis and financial collapse. Does Professor McDonough think our narrow tax base and, in particular, the absence of a property tax played a role in what happened in Ireland?

Professor Terrence McDonough: I certainly do think so, and I am fond of making the point that if we were to have a property tax, we ought to tax all property not simply the property that the ordinary Irish man or woman might own. The property tax as it stands only applies to the family home. Why discriminate against the family home as a form of property? Let us tax property across the board.

Deputy John Paul Phelan: As somebody who was very young in 1987, I cannot say I have instant recollection of everything from that period. Professor McDonough and Deputy Eoghan Murphy referred to the formation of social partnership. I want to dig deeper into Professor McDonough's comments about the threat of Thatcherism being introduced in Ireland. He implied that the unions felt they had to enter into social partnership to avoid Thatcherism. I have never heard of this before and I would like to know the basis on which he makes this assertion.

Professor Terrence McDonough: As the Deputy was speaking I was trying to remember where I was in 1987. I think I was teaching economics in Buffalo, New York. I remember, quite vividly, some friends of mine in an industrial union trying to leaflet a windscreen wiper plant in the city which was threatened with being moved to Mexico at the time of the maquiladora investment programme. As they tried to hand out leaflets people ran from them as they did not want to be seen accepting the leaflets, believing they would be the ones to be laid off when the plant moved most of its operations to Mexico. In this period there was a sharp decrease in the bargaining power of labour and that was expressed in the policy which the Thatcher Administration pursued. This policy was watched extraordinarily closely here and there would have been a dereliction of duty had it not been.

Deputy John Paul Phelan: Does Professor McDonough have any Irish example of the threat of Thatcherism?

Chairman: The Deputy is out of time.

Senator Marc MacSharry: I thank Professor McDonough for coming along. What alternative to social partnership would he have used?

Professor Terrence McDonough: That is a difficult question to answer. Ireland's labour leadership in that period faced difficult times and made a decision to enter into the social partnership arena. I am not necessarily critical of the arena itself as it was just another forum for negotiation. However, I would be critical of the result, although this result unfolded over a long period of time.

Senator Marc MacSharry: What are the professor's thoughts on the relationship between the union leadership of the time and its membership?

Professor Terrence McDonough: There needs to be a much closer relationship between the membership and the leadership, for good or ill. This is a general point and not specific to Irish trade unions. Social partnership was, at the end of the day, inimical to that. Trade union leaders were in closed rooms negotiating with employers and Government representatives rather than in touch with their membership and that is a problem with social partnership.

Senator Marc MacSharry: I do not hear an alternative though. If negotiation is not the way, what would the alternative be?

Professor Terrence McDonough: Things would have been better with more of a wage-led growth strategy. That would have necessitated a more militant approach to bargaining rather than trading a moderate approach to bargaining for income tax cuts.

Senator Marc MacSharry: Would that mean disputes, protests, lost days etc?

Professor Terrence McDonough: Yes. That is the price of a conflictual system.

Senator Marc MacSharry: Professor McDonough said that on 29 September 2008, in the dead of night, Ireland desperately tried to signal for help but a cannon broke loose the ship and holed the ship of state below the water line. Can he expand on this? What could or should have been done when Ireland signalled for help on that night?

Professor Terrence McDonough: I have a strong opinion on what should have been done with the banks. I am a little hesitant to bring it up lest I be accused of, to use an American term, “Monday morning quarterbacking”. I suppose the closest Irish phrase is “hurling on the ditch”. The Government should have nationalised the good part of the banks and left the bad part of the banks in private hands. It should have taken over the deposits, which are not assets but liabilities. It should have taken a corresponding amount of assets, which would have included the buildings, office, equipment and general management structure of the banks, and left the bad loans to be worked out in a very capitalist and very private way.

Senator Marc MacSharry: Professor McDonough said earlier that he favoured higher taxation and talked about the reduction from 60% to 48%. If tax reductions were to be offered now, would he see this as a repeat of the mistakes of the past?

Professor Terrence McDonough: Yes. I do not favour the current trend of taking advantage of the small upturn in the economy to cut taxation, and certainly not the top rate of taxation.

Deputy Pearse Doherty: Professor Edward Kane gave evidence to this inquiry earlier in the year. He had said in a 2004 paper that, while policy making during a crisis may be of the seat-of-the-pants variety, the policy itself is informed by a political and economic struggle over who pays for the losses. What is Professor McDonough’s opinion of that statement? Does he agree or disagree with his assessment of crisis policy making as a political and economic struggle?

Professor Terrence McDonough: I think it is fundamentally accurate. The question facing policy makers here, working in the context of the European Union and other global institutions, is basically one of who is going to pay for the crisis. The banking solution which I just proposed is simply one in which bondholders and lenders should have paid. To the extent that they were not going to pay, the question should have been transferred to the people who had the money. The people who had the money is the European Central Bank.

Deputy Pearse Doherty: What were the political and economic power blocs at play in the context of the Irish crisis?

Professor Terrence McDonough: I am not a political sociologist but the very close relationship between political parties, Government Departments, the construction sector and the banking sector was not helpful.

Deputy Pearse Doherty: In an article of 2010 entitled "The Irish Crash in Global Context" Professor McDonough stated that financialisation was facilitated by the neoliberal push for deregulation. This committee has heard evidence relating to the deregulation of the banks and the impact that had on the banking crisis. Can he explain why, in his view, there was a push for deregulation? What purpose does deregulation serve?

Professor Terrence McDonough: In the context of the Irish situation deregulation was very much in service of a strategy of internationalisation. This strategy had been seen to be successful and it was the basis on which policy makers were thinking about economic policy in the future. It was transferred directly to the financial sector with the push for the IFSC and then people asked what they could do to attract investment into this sector of the global economy in Ireland. The basic thing to do was to offer them a free hand and that is what I think was done.

Deputy Pearse Doherty: We have discussed light-touch regulation and deregulation in the past and Professor McDonough has given testimony on the subject of the amounts of money going through the IFSC. Do we have light-touch regulation of the IFSC now or is it a thing of the past?

Professor Terrence McDonough: I have not seen the kind of efforts to regulate finance in Ireland that would be obvious and sensible in light of the severity of the crisis that was created. There seems still to be a very close relationship between the IFSC and Government Departments.

Deputy Pearse Doherty: In the context of the IFSC, are the ingredients of the perfect storm, to which Professor McDonough referred earlier, still there or have they disappeared?

Professor Terrence McDonough: One would have to ask whether some of the immediate contributors to the storm had been dealt with. High levels of inequality and debt persist. We have been very slow to take aggressive actions to reduce debt levels. In this morning's newspaper the EU is reported as raising the issue, although it is somewhat ironic in that some of the debt is due to EU policy. We have moved from a low-tax regime and have not been able to restore productive investment, rather than financial activity, in the Irish economy.

Deputy Pearse Doherty: Yesterday, Professor Gregory Connor came before the committee and he said:

> ...a misunderstanding of the big risk of systemic liquidity problems in the banking sector. That was also missed. As such, the economists share some blame.

Would Professor McDonough agree or disagree with Professor Connor's statement that there was a misunderstanding of systemic liquidity problems and, if so, why did the misunderstanding occur?

Professor Terrence McDonough: The second part of the question is the relevant one. Clearly, there was a misunderstanding, and we need to ask why. It goes to the basic world view shared by economists, Irish policy makers and many political parties and other influential people, that the world is such that markets are efficient. The world is not that place.

Senator Susan O'Keeffe: When Professor Ed Kane came before the inquiry he said there was a tendency to regard bankers as high priests. Does Professor McDonough have an opinion on this?

Professor Terrence McDonough: Interestingly, this came up as one of the main topics of discussion some years back when I was interviewing a politician for a magazine article, which is not something I do every day. People such as Michael Fingleton and Sean Quinn were seen as gods somehow, and they were the "go to" people for economic advice.

Senator Susan O'Keeffe: Was that a tendency at the time?

Professor Terrence McDonough: Certainly, yes.

Senator Susan O'Keeffe: The medium-term review published by the ESRI in 2008 stated, among other things, "the fundamentals of the Irish economy are sound". From Professor John FitzGerald's evidence to this inquiry we know the ESRI had done no research on the financial sector for a number of years. Can an economist ever say the fundamentals of an economy are sound without examining the financial sector?

Professor Terrence McDonough: No, and the real question is why you people keep inviting the ESRI back. Its record is terrible.

Senator Susan O'Keeffe: Could Professor McDonough expand on that?

Professor Terrence McDonough: It did not call the crisis and it has not called the recovery from the crisis. What good is it?

Senator Susan O'Keeffe: On that note, if one were to examine any economy, would one, as best practice, include the financial sector as part of the activity?

Professor Terrence McDonough: Absolutely. To be fair to my colleagues, there is a trend to be more serious about the financial sector. The models used to model the Irish economy did not include the financial sector because it was thought that money was simply a veil and not a very important institution and, as an institution, a source of instability.

Senator Susan O'Keeffe: Was the ESRI alone in thinking the financial sector did not matter?

Professor Terrence McDonough: Not at all. It was the conventional wisdom. The ESRI was not alone.

Senator Susan O'Keeffe: On page six of Professor McDonough's statement, he described the IFSC as "an important conduit for foreign capital flows". Is he saying the existence of the IFSC was what allowed the flow of foreign capital and had it not existed, there could not have been such a flood?

Professor Terrence McDonough: There is a famous controversy in the economic history of the US as to whether railroads were key to the development of the interior of the country. The argument is that had the railroads not been there, people would have dug canals, therefore railroads were not key. One cannot make such an argument very convincingly. While it is probably true that other conduits would have been found for bringing finance into the Irish economy, the IFSC was a very important conduit for it in practice.

Senator Susan O'Keeffe: When Professor Gregory Connor gave evidence he said 88% of GDP was coming in as hidden borrowing through the banking system, and we are on the hook for it. How did we arrive at such a position?

Professor Terrence McDonough: Because we were not watching the domestic banking system and because our partners in Europe were not watching their banking systems very effectively. There were two players in the drama.

Deputy Kieran O'Donnell: This is a banking inquiry and we are speaking about neoliberalism in terms of what Professor McDonough feels were the policies pursued since 1987. Can he condense his philosophy and the economic and social model he would espouse and like to see? He referred to a creative process. Could he define it in a word?

Professor Terrence McDonough: No, I certainly would not define it in a word. In terms of addressing this economic situation, I would examine the origins of the problem and the solution that might be achievable. In the short to medium term, we would need to replace stagnant wages with rising wages, sluggish private investment with increased public investment, a hollowed out neoliberal State with a more active State, and unregulated private finance with public banking. The euro without a transfer union needs to be a euro with a transfer union or we need to find a way of mutually exiting this particular straitjacket. We have a dysfunctional ECB and we need a functional one. In Ireland we need redistribution, a debt write-down and higher tax take.

Deputy Kieran O'Donnell: How would Professor McDonough finance this?

Professor Terrence McDonough: We are under-taxed. We need continental levels of taxation. That is one way I would finance it.

Deputy Kieran O'Donnell: Define that in terms of rates and the tax base?

Professor Terrence McDonough: I certainly would not give the committee an entire breakdown of rates, but we need to move from the low 30% into the high 40% in terms of the percentage of GDP we take in through tax.

Deputy Kieran O'Donnell: We are talking about all across the range - income tax, corporation tax-----

Professor Terrence McDonough: I would be talking largely about income tax.

Deputy Kieran O'Donnell: Would Professor McDonough be talking about wealth tax?

Professor Terrence McDonough: It should play a role. The French model in that respect is a starting point, at least.

Deputy Kieran O'Donnell: I have two more quick questions. How could the type of model Professor McDonough has articulated and espoused have prevented the banking crisis? What measures would he like to see put in place now, which he feels would prevent a future bank crisis?

Professor Terrence McDonough: The proposals I am making are very much in the context of the current period. Something similar would have had positive effects on the banking crisis. The banking crisis was not felt uniformly across the world. The South American nations with strong capital controls were relatively unscathed. Nations with strong banking regulation, like Canada, experienced less of a problem. Therefore, I think something like this would have been better than what we had. If, for instance, we had a much larger public banking sector - as they have in North Dakota, for example, strangely enough - we would have been able to weather this a good deal better.

Deputy Kieran O'Donnell: Professor McDonough spoke earlier about controls over the flow of credit. In practical terms, how could the Government of the time and the Central Bank have done that? What impact would higher taxes have on employment growth?

Professor Terrence McDonough: It is interesting. We have forgotten that in the post-Second World War period, almost all countries had rather tight restrictions on capital flow. This was one of the bases for the rapid growth in standards of living. Controlling capital flows is not inconsistent with economic growth. Regarding the impact of higher taxation on employment, it is not so much the level of taxation as the level of organisation, innovation, participation and democratic commitment to the productive activities in society that determine the level of employment growth. Higher wages would lead to higher demand and more employment.

Chairman: When Peter Nyberg was before the committee, one of the comments he referred to related to the social partnership model and how expenditure grew in public sector wages. Is Professor McDonough familiar with that part of the Nyberg report and would he like to make a comment on it?

Professor Terrence McDonough: Specifically, he would have been critical of the level of public sector wages.

Chairman: Yes.

Professor Terrence McDonough: The problem is not so much the level of public sector wages as that the level of wages in the private sector did not follow those in the public sector. That is, we needed a wage-led regime. It would have been better. Public sector wages establish a benchmark, although I hesitate to use that word, for the private sector. I do not think we should be benchmarking the public sector on the private sector, but we should be benchmarking the private sector on the traditional labour protections that public sector unions have been able to achieve for their members.

Chairman: That is a standards in employment issue. In terms of a wage issue, which is also an equality issue, the benchmarking that took place was the public measured against the private. Does Professor McDonough have a view on that?

Professor Terrence McDonough: Generally, good public services are preferable to very high wages. The question of public sector wages is not a single question-----

Chairman: Specifically on the Nyberg report, does Professor McDonough agree with the-----

Professor Terrence McDonough: If one looks at the higher reaches of the public sector, yes. The higher reaches of the public sector are overpaid. If one looks at the lower reaches of the public sector, one finds that they are a little better paid than similar jobs in the private sector, but this is because the public sector does not discriminate against women to the same extent that the private sector does in those lower-paid jobs.

Chairman: To finish up, two economists were in the Oireachtas recently. It was not with this committee, but with the social protection committee. One of them was Professor John FitzGerald and the other was Dr. Dónal de Buitléir. Professor FitzGerald said, “The overall impact of Government policy on expenditure and taxation of successive Governments has had a progressive impact.” Dr. Dónal de Buitléir stated, “The fact is that we have the most progressive tax and transfer system in the OECD both absolutely and proportionately.” Would Professor McDonough have a view on those two statements?

Professor Terrence McDonough: I think those two statements are quite literally true. This was the finding of the recent TASC report. What we have to start with is the most unequal market distribution of income in the developed world and after taxes and transfers, we end up with something much closer to the average.

Chairman: Is there anything else Professor McDonough would like to add before we come to a conclusion?

Professor Terrence McDonough: No, I think I have been talking a lot.

Chairman: With that said, I thank Professor McDonough for his participation. It has been a very informative and valuable meeting, which has added to our understanding of the factors leading to the banking crisis in Ireland.

Sitting suspended at 2.10 p.m. The joint committee resumed in private session at 2.25 p.m. and adjourned at 4.15 p.m. until Wednesday, 4 March 2015.