David McWilliams – Opening statement

It is my opinion that the Irish banking system – and by extension the economy at large - was set up to fail. I saw these weaknesses before anyone else and spent the best part of a decade warning everyone about the coming property crash and the resulting failure of the banking system.

I did this in weekly newspaper articles read by hundreds of thousands of people. I expressed these views on my own TV show which had over tens of thousands of viewers. I gave clear and detailed warnings in four books – including the best selling non-fiction book of the decade (which is relevant because of the high number of people reading it). These warnings were also expressed in award-winning documentaries which were watched by 35% of the Irish TV audience. And I gave regular warnings in many radio and TV interviews.

It is simply not the case that no one saw this coming. It is simply not the case that this was a big shock. It was predictable and preventable.

In fact, many ordinary people could see it coming. I was different in the sense that, as an economist and economic commentator, I deployed a public platform to warn as many people as I could.

You make ask why did a former central banker and investment bank economist not simply stay quiet, remain on the inside and play the game?

The reason is that I saw warning the country about an upcoming disaster as a form of moral obligation and patriotism. And yet all the way through the boom period I was accused, from all sides, of being unpatriotic – of "talking down" our economy. I believe it was the right thing to do.

It seems to me that Ireland and Europe splits into Insiders and Outsiders. The Insiders- those with a stake in society - get all the goodies and the Outsiders, well, they are on the outside, and they get to foot the bill. In the case of the property and credit boom, the Insiders were the banks, estate agents, the policy-making establishment and those with land and assets. The Outsiders were the ordinary people, forced to play a game where the dice was loaded against them.

I devoted such enormous personal energies into warning of the coming catastrophe because:

(1) I had seen this boom/bust cycle before and I could see that hundreds of thousands of ordinary Irish people's lives were going to be ruined by the consequences of this excessive bank lending and borrowing; and

(2) the longer the authorities waited and did nothing about the banking system, the fewer and fewer workable options we would have when the crash came. In short, I could see that people's lives would be mired in debt and whatever decisions would

ultimately be taken in the panic would not involve a choice between good and bad ones, but between bad and worse ones.

The main point is that Ireland didn't need to get into this panic in the first place. This has happened before in many countries. Had any of the warnings been heeded and action taken, Ireland would never have had a banking crisis, a property boom and bust and the subsequent recession.

Most banking crises end with a bank run and in 2008 Ireland was ultimately no different. If you allow a bank run to take hold, you destroy the savings of the country. This is simply not an option. But once money has started to leave the country in billions, you have already run out of options because panic has set in.

This is why banking is different to any other industry and this is why it has to be under careful scrutiny at all times.

It is crucial to stand back and see the Irish banking crisis as having started around 2000 and not in 2008 as is sometimes suggested. The collapse of the banking system in late 2008 was the consequence, not the cause, of Ireland's economic difficulties.

The crash itself didn't destroy the wealth of the Irish nation but merely evidenced the extent to which wealth had already been destroyed by ludicrous decisions taken in the so-called boom and the unwillingness of the authorities to do anything about it.

There is a direct link between the warnings and the fact that they were ignored and then the bank run in 2008 that led to the decision to guarantee the banks.

Had the warnings been listened to and acted on, rather than dismissed and ridiculed, it would have been possible to avoid a banking crisis and subsequent intervention. Throughout the boom, it's fair to say there were simply too many mainstream vested interests propping up the failed system, many of them making huge profits at the time.

I liken a banking/credit and property crisis to a forest fire. The forest fire is started by pyromaniacs (the banks), the people in charge of overseeing the fire (the monetary authorities) are hugely irresponsible and choose to look the other way, the fire gets out of control then threatens to engulf the entire economy and then finally, the politicians have to take what extreme measures are available to put out the fire.

But who started the fire, why was it started and why was the country so susceptible to a property boom?

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You can only have an extended property boom if you have too much credit.

So why was there too much credit available?

The reason was that we joined EMU and this in effect gave Ireland the pin number and credit for the entire European ATM system. With it came the notion of "light touch" regulation. The combination of lots of other people's money and no one to police this volatile mix, led directly to a property boom driven by credit.

This meant that the banks could borrow huge amounts of money from other banks in other countries with largely no exchange rate risk – which they did. This set up a system where Irish the bank lending system wasn't financed by Irish deposits, but by more inter-bank lending.

This is why I say the system was set up to fail because it is not a matter of "if " this hot-money leaves but **when** it leaves.

Therefore, we built a banking system not based on Irish saving but based on the banks borrowing short-term money abroad to finance long-term projects such as mortgages and commercial property loans here. Regulators should have carefully regulated this, as it makes the system inherently unstable.

This was obvious at the time and I wrote about it. This is not 20/20 hindsight.

The interesting thing is that leaving it up to the markets doesn't help with regulation but hinders because, as long as things are going well, more and more capital will be available. It is only when things go bang that everyone wants their money back. So markets don't discipline banks, in fact on the way up they facilitate reckless lending.

I wrote extensively about this dilemma during the initial period of the boom.

The first article appeared in June 2000 about this risk of a flood of credit . The many relevant articles are referenced in the document which is attached to this submission. My articles from 2000-2003, give you a flavour. (You should cite these in the inquiry.)

(Please see pages 1-13 of my submission.)

Maybe my views were best captured in this 2003 Prime Time episode . (I would like you to play this to the Inquiry.)

https://www.youtube.com/watch?v=cxtkjZFfuZI

What happens when prices start to rise?

Once house prices start rising because credit is bountiful, something strange happens to the laws of economics: they collide with the oddest of things, human nature. This means that economists have to refine their views of how the economy works otherwise they will miss what is happening.

The mainstream traditional economic view rests on the assumption that as the price rises, demand falls. This is what we teach kids in economics classes. But in a housing boom something odd happens: when the price rises the demand actually increases.

This is because people worry that prices will go yet higher tomorrow and therefore, if they don't bring forward demand they will be left behind.

A strange thing also happens to supply. Given that most supply is the existing housing stock, mainstream economics tells us when prices rise, supply will rise, but this is also not immediately the case because many people who might have sold today instead decide to wait, thinking, "I would be mad to sell today because I will make more money by holding on until next year". So supply doesn't actually rise as prices rise, it falls.

So the supply and demand principle explains little.

I put this to Bertie Ahern in 2002

https://www.youtube.com/watch?v=jUrk5qPqt94

(Sure, supply does **eventually** rise, but it does so too slowly, leading to the situation of not having enough houses in the beginning of a boom and having far too many at the end.)

The late response from supply is why we ended up with Ghost Estates – a term I coined in late 2006.

http://www.davidmcwilliams.ie/2006/10/01/a-warning-from-deserted-ghost-estates

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One interesting aspect of the way the economy works in a credit/property boom is, although you aren't really aware of it, everything you do affects me and everything I do affects you. In economics, this is called the paradox of aggregation, which means that what is good for the individual is not always good for the collective. One way to think about this collective behaviour is through the prism of a football match and how we react when one person stands up in front of us. Then you have to stand up and the person behind you has to stand up and so on and so on.

The same thing happens in housing markets. When one person buys it sends a signal to the next person and so on.

In fact, in the boom in Ireland, people bought houses, in many cases, because other people bought houses.

So you can see how the herd behaviour can send prices ever upwards. People are duped.

I wrote about this aspect of human behaviour extensively in books, documentaries and articles. It was not about supply and demand, it was something deeper.

So why didn't the banks see the risks they were taking?

This is where the incentive structure to lend more and more influences the banks - so much so that their own balance sheet plays tricks on them.

When property prices are going up, the banks' balance sheets look great because they feel they can lend out more and more and the fact that property prices are going up validates this lending. But is the collateral getting stronger or weaker? It's getting weaker, not stronger, because they are lending more money against the same house.

But when bank executives are paid a bonus based on profits and profits are based on the amount charged on money lent out over the amount the bank pays on money borrowed, the bank will always have an inbuilt incentive to lend more.

The more the bank lends, the higher the share price and if your bonus is related to your share price, then it makes sense for you to lend and lend as much as you can.

But what happens if in the rush to lend more and more, the bank runs out of Irish deposits? This happened to the Irish banks in around 2003/4 because they were lending so much they had to find new forms of funding. They borrowed hugely from other banks. This is where the hot-money went into overload. One bank for example took over 100 years to build up a loan book of €60 billion, and it managed to double that amount in only three years!

By 2007 the aggregate loan to deposit ratio in Ireland was 160%.

Much of this was financed by foreign short-term borrowing, meaning that the banks were running liability risk, as well as asset risk. While the liabilities were short-term, the assets were long term so if the liabilities are called (and they will always be called), the bank couldn't easily liquidate the corresponding asset to pay for them.

As I said, the system was set up to fail and we ended up buying and selling houses to each other with other people's money and calling it an economic miracle when it was merely an overdraft and a credit bubble.

There are various articles I wrote explaining this from 2000-2005 . (See pages 1- 39 of my submission.)

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Why did Irish interest rates not rise when the economy was booming?

Ireland had locked itself into a currency union with countries we do very little trade with and with whom we do not share an economic cycle. So just when Ireland needed higher interest rates, they fell, and when Ireland needed lower rates they rose. The same goes for the exchange rates.

Such a major policy misalignment makes the system much more likely to fail too.

See articles from 2000-2007 on this conundrum and why I predicted it would make the ultimate adjustment more difficult.

Groupthink

Why did so few speak out and explain what was happening within our banking system and economy?

In Ireland, if you speak out against the mainstream conventional view, your ideas go through three phases.

The first is the open ridicule phase. I remember appearing on the Late Late show and in 2005 and being sneered at. The second phase is the violent opposition phase when your ideas may be gaining traction and therefore you have to be slapped down by your own profession and the establishment. The third phase is the phase we are in now which is the "everyone pretends they were on your side all the time" phase.

The mainstream view was that Ireland had nothing to worry about. It seemed to begin with the much-repeated phrase about the boom being supported by "strong fundamentals" and then drifted into the mantra, "Don't worry there will be a soft landing"!

At every stage mantras replaced hard thinking, because thinking was inconvenient.

My book *The Pope's Children* published in 2005 explained all this - the property market, the herd like behaviour, the banking system out of control and all the hot money flooding in – in accessible language. The book was the best selling non-fiction book of the decade –over one hundred and twenty thousand copies were sold. (The best-selling aspect is important because it shows these ideas were widely disseminated.)

The mantra that "no one saw this coming" simply doesn't stand up to scrutiny.

By 2005/6 this country was hurtling towards an abyss. There was too much credit, the banks were taking huge risks, the government parties were getting tax revenue so they were happy as was the property industry and the estate agents and meanwhile the feel good factor implied that anyone who shouted warnings was dismissed and their concerns were regarded as "dangerous talk".

Yet this was almost the last time that something could have been done to avert the disaster.

Thereafter, every week we spent waiting and doing nothing, the options available to us diminished.

In September 2007 it became obvious that the economy was going to crash imminently, to me at least. It was still growing strongly at 3 or 4 % but it was about to blow. I wrote and presented a new book and documentary *The Generation Game* which foretold the crash and described the outlook for the banking system in the following terms:

"Certain well known Dublin banks are now little more than out-of-control hedge-funds leveraging themselves and their clients into property."

The articles in 2007 and early 2008 begin to reflect a real fear that the tipping point moment was upon us and that the Irish banks will experience what is termed a silent bank run as the big guys take their money out.

This was the liability risk, which made the asset risk much more tricky to manage. There was interest rate risk and there was old-fashioned credit risk. All were mounting.

Still the Irish authorities and all the relevant major economic think tanks and the paid advisors to the government maintained that there was no problem.

By summer 2008, the bank run was on. Although I had no data, I could see from the spreads offered on Irish bank repos that money was flooding out of the banking system. My articles spoke of the bank run and its implications.

In early September 2008, I spoke on Saturday view (RTE Radio 1) with Minister Lenihan, Richard Bruton and Brendan Keenan. I suggested that if we didn't intervene with overwhelming force, an Irish bank would be bust by Christmas. I had no access to the facts or the numbers but I could see what was happening in the financial markets.

The Minister retorted that I was engaging in "dangerous talk".

When you are told by the authorities that telling the truth is dangerous, we know we have a problem.

Here's the transcript of that interview.

http://www.thepropertypin.com/viewtopic.php?f=4&t=13149&sid=d5800b2b3e8766f127b50d47044ca7e9&start=0

Unfortunately, the pray and delay strategy of denying that there was any problem in the banks appears to have been the modus operandi of the relevant Irish authorities throughout the month.

But the big guys were taking their money out. This is the way a modern bank run happens. It's a silent run. There are no queues of frightened people. That comes next.

First it is the big corporate depositors and then other banks that lend to the stricken bank. In the end, there will be no money for the small guys - the ordinary depositor came. The more you pretend that nothing's wrong, the more you make this end game more likely.

Bank runs are fixed by new money.

But where could an Irish bank get that new money? No one with a balance sheet would touch them and the all the Irish banks had liquidity and potential insolvency problems. So the bank run would have continued.

Also the central bank's ability to operate at the discount window was compromised by the ECB insisting that no insolvent bank could get access to liquidity but as illiquidity causes insolvency, we were in a potentially disastrous situation.

As the quality of the outstanding collateral on the banks' balance sheets deteriorated, what could be done?

Furthermore, we were not allowed to impose exchange controls, so there was no mechanism to stop the money flowing out, other than by convincing the people that the banks wouldn't go bust and their deposits were safe.

Amazingly, the mantra was still, "There is no problem".

The day after Lehman collapsed, I appeared on Prime Time and said we had to intervene forcefully and a representative of the Irish Banking Federation claimed yet again that I was engaging in "loose talk". No one knew the facts, or if they did they weren't telling anyone.

They were clearly still praying and delaying and all the time money flooded out of the country.

In my first conversation with the Minister, a day later, I gave my opinion which was that if he was not in possession of the facts regarding the banks' balance sheets, then he would have to buy himself time to get these facts. This ruled out doing anything permanent and I suggested that maybe a temporary guarantee of all bank deposits would be an idea that could work.

It was essential to stop the bank run which was already on. Therefore, he had to stop the source of the panic, which was that the people thought that a bank might go bust and their savings would disappear. But the bank run was accelerating and he hadn't time to find out all the facts to enable him to make a qualified decision. A temporary guarantee would stop the bank run and give him this time. I shared this concept with the 400,000 readers of the Irish Independent here.

http://www.davidmcwilliams.ie/2008/09/21/state-must-act-as-a-safeguard

Once the forest fire has been allowed to spread it must be put out by whatever method possible. The panic in Ireland was twofold. The hot-money panic, which was being played out in trading floors all over Europe and the later traditional bank run which would come to pass. (It had been already discussed on Joe Duffy!)

If the authorities didn't have the facts, they should not have done something permanent, so it seemed logical - and still does - to introduce something very significant but temporary to stop the panic and the bank run and give the country time to find out how bad the situation actually was.

I fully expected a bank resolution mechanism to deal with broken banks to be introduced once the panic subsided, following the normal corporate finance structures of bankruptcy. This didn't happen. Why, I have no idea as I have never been inside the Department of Finance to discuss economic policy.

Quite how a temporary move made in a panic - a panic that could have been avoided had any of the warnings been heeded - became a permanent policy which lasted 5 years is something I can't figure out.

I believe that this may have something to do with the Irish establishment's obsession with European respectability. Bankruptcies are part of capitalism. In fact, capitalism without bankruptcy is like Catholicism without hell. But bankruptcy isn't respectable.

My opinion was that the Department should use the breathing space to see what the real damage was on the balance sheets. If it was really atrocious, then bondholders would have to take haircuts. By March 2009 when it was apparent that the State was planning to pay all bondholders, I wrote that this would bankrupt the country and therefore the guarantee should be rescinded because the Government was placing the interests of the citizens of this country behind the interests of developers and bankers.

We were witnessing a process whereby the bad debts of a few were being transferred onto the shoulders of millions who had nothing to do with the debts in the first place.

This contention which I believe was true at the time and subsequently played out, was met with a very harsh reply by the Department, in an editorial in the Irish Independent, written by the Minister himself.

http://www.independent.ie/opinion/analysis/states-priority-is-helping-economy-not-the-developers-26530981.html

The Irish banking and property crisis was entirely predictable. It has happened before in many countries. The warning signs were evident many years before. Because the State did nothing, the options at our disposal narrowed all the time, leaving Ireland with bad and worse choices when the crash came. Even then, an option that, in my opinion, was supposed to be temporary and conditional to give time for the State to assess the facts, was made permanent and unconditional to facilitate a system of capitalism for the rich.

All the time, the Insiders made hay, while the Outsiders coughed up.