

# HOUSES OF THE OIREACHTAS

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

### JOINT COMMITTEE OF INQUIRY INTO THE BANKING CRISIS

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*Dé Céadaoin, 24 Meitheamh 2015*

*Wednesday, 24 June 2015*

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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.

**Nexus Phase**

**Department of Finance - Mr. John McCarthy**

**Chairman:** The Committee of Inquiry into the Banking Crisis is now in public session. And can I ask members and those in the public Gallery to ensure that their mobile devices are switched off. We begin today with session 1, public hearing with Mr. John McCarthy, chief economist, Department of Finance. In doing so, I would like to welcome everyone to the public hearing of the Joint Committee of Inquiry into the Banking Crisis. Today, we continue our hearings with senior officials from the Department of Finance who had key roles during the crisis period. At this morning's session we will hear from Mr. John McCarthy, chief economist, Department of Finance. John McCarthy joined the Central Bank as an economist in 1996 but has spent most of his career on secondment to the Department of Finance. At all times in the Department, he worked in the economic section of the budget and economic division. He was appointed chief economist at the Department in November 2013 following an open competition. Mr. McCarthy, you are very welcome before the committee this morning.

Before hearing from the witness, I wish to advise the witness that by virtue of section 17(2) (l) of the Defamation Act 2009, witnesses are protected by absolute privilege in respect of their evidence to this committee. If you are directed by the Chairman to cease giving evidence in relation to a particular matter and you continue to do so, you are entitled thereafter only to a qualified privilege in respect of your evidence. You are directed that only evidence connected with the subject matter of these proceedings is to be given. I would remind members and those present that there are currently criminal proceedings ongoing and further criminal proceedings are scheduled during the lifetime of the inquiry which overlap with the subject matter of the inquiry. Therefore, the utmost caution should be taken not to prejudice those proceedings. Members of the public are reminded that photography is prohibited in the committee room. To assist the smooth running of the inquiry, we will display certain documents on the screens here in the committee room. For those sitting in the Gallery, these documents will be displayed on the screens to your left and right. Members of the public and journalists are reminded that these documents are confidential and should not publish any of the documents so displayed.

The witness has been directed to attend this meeting of the Joint Committee of Inquiry into the Banking Crisis. You have been furnished with booklets of core documents. These are before the committee, will be relied upon in questioning and form part of the evidence of the inquiry. If I can now ask the clerk to administer the oath to Mr. McCarthy, please?

*The following witness was sworn in by the Clerk to the Committee:*

Mr. John McCarthy, Chief Economist, Department of Finance.

**Chairman:** Once again, thank you Mr. McCarthy for being here this morning, and if I can invite you to make your opening remarks to the committee please.

**Mr. John McCarthy:** Sure, thank you, Chairman, and thank you members of the joint committee. I can be very brief, Mr. Chairman, as I have submitted a more detailed witness statement to the joint committee already. Just by way of introduction, you have directed me to give evidence relating to my role as chief economist/assistant secretary and all other roles in the Department of Finance. As you mentioned, I was appointed to the position of chief econo-

mist in November 2013. Prior to that I worked at a technical level in the Department, at grades equivalent to that of assistant principal and principal officer from about 2001 onwards, with the exception of 2004 when I was back working in the Central Bank. For the most part, during this period, my work involved producing economic forecasts for the Department, as well as undertaking some technical work on the public finances, mainly related to the Stability and Growth Pact, the structural budget balance, fiscal stability treaty and so forth. Please let me briefly summarise the, the main points of ... or what I see as the main points of my witness statement.

As I've outlined, the stance of macroeconomic policy during the first decade of monetary union was completely inappropriate. While monetary policy was exogenous, it was determined externally by the European Central Bank with regard to economic conditions in the euro area as a whole, fiscal and incomes policies in Ireland should have been counter-cyclical with the view to stabilising aggregate demand in the Irish economy, which was essentially operating at full capacity or even beyond full capacity for most of this period. The contraction of the tax base and the ramping up of public expenditure on a permanent basis were clear policy mistakes and ultimately led to a very large structural deficit once the crisis kicked in. That the public finances were in broad compliance with the requirements of the Stability and Growth Pact during most of this period provides no comfort.

Let me say a little bit on the ... on the Department's warnings. The Department did advise, both internally and externally, regarding the pro-cyclicality of fiscal policy, regarding the loss in competitiveness, as well as the over-dependence of the economy on new house building and construction more generally. This is acknowledged in various reports, Wright and Nyberg being good examples. However, it is also clear that the Department should have adapted the tone of its warnings as the imbalances were becoming more acute and I would certainly agree with this analysis.

Now, in relation to the housing market, the general approach in the Department was to highlight the central scenario of a soft landing but also to outline, in various internal memos and so forth, that there were risks to the ... to this ... such a benign outcome. I think it's important on the outset to stress what is meant by a soft landing. This was the assumption that prices would level off or even decline moderately so that with continued consumer price inflation, real house prices would realign with fundamentals over time. In addition, it involved the assumption that activity would revert to more sustainable levels in a gradual manner, rather than in a very disruptive manner. Clearly a soft landing did not materialise and this was an incorrect call.

Finally, if I could just say a few words on the resources of the Department, and specifically within the economic division. Certainly, when the crisis hit there were very few economists working in the economic division. The number of people that I would consider as technical economists you could count on one hand, I think it's fair to say, in the division at that time. But I think it's fair to say the picture has changed in the intervening period with improved resourcing, especially on the quality. Okay? I think we are now approaching a critical mass of economists within the Department and we are publishing some of our technical work, something which never happened before, and we are engaging in a more structured manner with the wider economic community. So, from an economic perspective, I think it's fair to say that the Department is in a much better place now. Chairman, with this brief summary I will conclude my opening statement. Thank you.

**Chairman:** Thank you very much for your opening remarks, Mr. McCarthy, and if I can invite our first lead questioner this morning, Senator Sean Barrett. Senator, you have 15 minutes.

**Senator Sean D. Barrett:** Thank you very much, Chairman, and I welcome Mr. McCarthy. I echo the Chairman's welcome to you. You were just saying there the critical mass of economists, what's the number that you would put on that?

**Mr. John McCarthy:** Within my own division, within the economic division, there are about 20 positions for economists. Not all of those are filled at the moment. I have about 15 people on my team. There are a number of vacancies including one crucial vacancy on the macro-economics side. I am holding that vacancy for the next month or two because there is an excellent economist employed in the Department but in another division, so I am willing to wait. When his job finishes there he will move across.

I think you need to look beyond the economic division as well, there are economists elsewhere in the Department and I also think it's important to highlight the fact that the role of the Irish Government economic and evaluation service, which was established I think in about 2011 or 2012, it is situated within the Department of Public Expenditure and the rationale for this is to create an economic service for the Civil Service as a whole. So there has been a large amount of recruitment there both at the AO level, there is currently recruitment ongoing at the AP level so the rationale and I'll finish here is to create a career structure for economists all the way up to and including chief economist which is at the assistant secretary grade.

**Senator Sean D. Barrett:** Outside your 20, how many other economists are there in the Department of Finance?

**Mr. John McCarthy:** I think the number with masters level degrees or more is just under 40. I think it's 37 or 38.

**Senator Sean D. Barrett:** The ones that moved across to public administration, public expenditure and reform, how many are there roughly? I know it's not your Department but-----

**Mr. John McCarthy:** I would have to hazard a guess and it would be an educated guess, there would be the guts of 40 or 50. That is a reasonable guess. It is not zero and it is not 200, it is somewhere of that magnitude.

**Senator Sean D. Barrett:** Thank you for that. Some of the literature says that those specialists should move on after three years. I take it that what you're doing is integrated fully into those departments and there wouldn't be a suggestion that specialists should depart the scene.

**Mr. John McCarthy:** Absolutely not. One of the problems in the past has been that there is this generalist versus specialist approach. I think there is a general recognition that there was a lack of specialist at the time. Not just in economics but I think in other areas as well. There was no career path for economists within the Department. John FitzGerald has spoken about this, I think in this forum, but certainly at other fora he has spoken quite a lot about this. He had to leave the Department because he felt if he wanted to move up he would have to move outside the economic space and into the sort of ... and that is what we are trying to address now is to create a career structure so you can join as an economist and you can move up the ranks as an economist. So as I mentioned, there is currently a competition under way for AP economists and as I said before you can go all the way up to my position, to assistant secretary, and remain an economist.

**Senator Sean D. Barrett:** Very good. Now 2003, did the interaction between the Government's economic analysis function with the economic research section of the Central Bank because of the restructuring and the creation of the Irish Financial Services Regulatory Au-

thority, did that change or was there a change in emphasis when the Financial Regulator was established in 2003?

**Mr. John McCarthy:** No, not on the economic side, Senator. The reason for that is that we would engage - when I talk about “we” I am talking about the economic division - we would engage with the Central Bank on an informal basis and the nuts and bolts of our discussion would essentially be about the short-term outlook for the economy. We would, sort of, exchange views on where things were going. There were a lot more people employed in the bank, so you could argue maybe there was a comparative advantage there but we would have informal discussions pretty much around the Central Bank’s quarterly bulletin, we would discuss where things were going. We might often, or from time to time, we might run some technical issues past the economic division of the bank, but this was purely in the macro-economic space. So, the whole rationale was to ... you know, if the bank were talking about a forecast of, we’ll say, X%, we would say, “Well, what’s the savings rate that underpins your consumption figure? What’s the exchange rate that underpins your export?” It was purely a technical discussion. We did not have, in the economic side, any dealings with the Financial Regulator.

**Senator Sean D. Barrett:** In your own core documents, on Vol. 1, page 38, what Nyberg says on that arrangement, Mr. McCarthy, is, “Had the DoF [Department of Finance] taken a greater interest in financial market issues early on, preparations for dealing with the financial crisis would have been more comprehensive.” So, in retrospect, was that a flaw in the way we organised the relationship between the Department of Finance and the regulator?

**Mr. John McCarthy:** The responsibility for dealing with the regulator within the Department was on the banking and finance division. My own department, or the department ... the section that I was engaged in, or employed in, was purely looking at macro-fiscal issues. We did not look at financial stability issues, so I couldn’t comment on any discussions that may have taken place between our banking and finance division and the regulator.

**Senator Sean D. Barrett:** Wouldn’t the two overlap, though, if you saw credit expanding at 25% a year? You know, that must have implications for the macroeconomic state of the country, so you couldn’t have remained immune from such a heavy increase, year after year, in the amount of credit that the banks were extending.

**Mr. John McCarthy:** Yes, no, I do think you’re making a fair point, Senator. I do think there was a lack of joining the dots, if you like, between the real economy and what was going on on the credit side. We tried to address that in 2006. I think there was a proposal to establish a working group within the Department and possibly involving others, to look at everything, to make sure everything was joined up, but at that stage, I suppose the horse had bolted and, from what I recall, the group never met.

**Senator Sean D. Barrett:** I see. And you mentioned Professor FitzGerald earlier. He said to us that there was a cultural change in the Department of Finance in the last decade, that they became more concerned about the politics of things and less interested in technical detail and he, in the ESRI, and yourselves had had less interaction. Did you have any response to what John FitzGerald was saying in that very chair?

**Mr. John McCarthy:** Two points on that. I think John FitzGerald, when he was in this chair, made reference to two sets of interactions between the ESRI and the Department. He referred to technical level discussions and he referred to political level discussions. He was quite complimentary regarding the technical level discussions and those technical level dis-

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cussions would have involved myself and some of my team. He expressed concern about the over-politicisation of some of the ... well, maybe I'll ... of some of the comments coming from other parts, or more senior levels, within the Department. They were very political. He was complimentary on the technical discussions. He has also ... my second point is he has also been very complimentary of the various changes that have taken place within the Department over the past couple of years: the fact that we now publish working papers; the fact that we now publish technical papers; that I speak at conferences, both domestically and internationally; that my team speak at conferences; that people have published in the *Journal of the Statistical and Social Inquiry Society of Ireland*; *The Economic and Social Review*. He has been quite complimentary about the technical capacity of the Department; less so about the over-politicisation of some of the-----

**Chairman:** Would you concur with Mr. FitzGerald's comments on the politicisation, Mr. McCarthy?

**Mr. John McCarthy:** Yes.

**Chairman:** Would you like to expand upon that?

**Mr. John McCarthy:** I do think, in my time in the Department, there were instructions given to people to, "Take this out; they can't say that; this is too political; get them to not say that." My own view is that independent thought, be it from the IMF or the ESRI, is actually good. The Department needs people saying controversial issues. So, I would agree that there was some over-politicisation.

**Chairman:** And where were those instructions coming from? Sorry about that now.

**Mr. John McCarthy:** They were coming from beyond my pay grade.

**Chairman:** Okay, within the public sector?

**Mr. John McCarthy:** Within my Department.

**Chairman:** Within your Department. Okay.

**Senator Sean D. Barrett:** And when we look at-----

**Mr. John McCarthy:** Sorry, can I just?

**Senator Sean D. Barrett:** Indeed.

**Mr. John McCarthy:** I did the technical work-----

**Senator Sean D. Barrett:** Yes.

**Mr. John McCarthy:** And then at a higher level, the instructions.

**Chairman:** Okay, thanks.

**Senator Sean D. Barrett:** When we look at Vol. 3 in the core papers, around pages 17 and 20, there's quite a lot of the same kind of factor that you refer to there, Mr. McCarthy, in relation to taking chunks out of IMF reports in Ireland. And particular, on page 17, their discussion of a deposit insurance scheme and, you know, a warning on page 12 that it would be:

[I]mportant to be prepared for the worst. In this context, pay-outs from the bank deposit

insurance scheme should be available more rapidly and the scheme better funded to reduce liquidity concerns in case a bank comes under pressure. Enacting an insolvency process specifically adopted to banks [would] should also be considered.

I mean, given what happened, wasn't it unfortunate that we ... that Ireland asked the IMF to take those chunks out? For instance, "the housing boom is over" was replaced by "the housing market cycle has turned", that, if we're going to rely on the IMF and the ESRI to say they supported what we were doing in policy, we shouldn't be engaging in, kind of, altering those documents before the public gets to see them.

**Mr. John McCarthy:** OECD report.

**Senator Sean D. Barrett:** Yes.

**Mr. John McCarthy:** OECD rather than IMF. Just the ... these were, they're not my own comments I would stress Senator, but I would agree with you. It is good to have people making these recommendations. Sometimes they're not entirely accurate and so forth, but they are good to provoke thought and certainly on the deposit guarantee scheme and some of those other issues, they were important. Just because there is a suggestion from somebody in the Department, and its not myself, that these be removed, does not mean that they were actually removed. This report, and its an OECD report I think from 2008, the twice ... every two years review of the Irish economy. That is ... the ownership of the report belongs to what's called the economic development and review committee of the OECD. So just because we ask for changes doesn't mean changes are taken. There is a meeting every ... there is a meeting around this and the committee can take on board any comments or they can delete comments and see them as inappropriate. But I would accept your point in the sense that it is good to have some of these recommendations. They may not necessarily be correct in all circumstances but it is good to provoke thought and it is good to have the debate as to whether they are relevant. But I would also point out, and it's the final point, every finance ministry in the world when they come to deal with the IMF or the OECD in this case, would come back with recommended changes. Some of them are just nuances, some of them are more substantive.

**Senator Sean D. Barrett:** Was the definition of competitiveness used when we were talking about competitiveness, too restricted? It seemed to be just the consumer price index and wage claims. Was the property influence on competitiveness, if you take that Deputy Higgins has repeatedly drawn attention here as you know, that the fact that house prices are rising by more than the average annual income in every year, so that must have been reducing Ireland's competitiveness and did that not set off alarm bells in discussions of competitiveness in the Department?

**Mr. John McCarthy:** The ... we looked at a number of measures of competitiveness. There is no single measure of competitiveness but the most comprehensive one that we would look at would be what's called the real effective exchange rate. So if ... essentially the effective or the trade weighted exchange rate adjusted for relative price developments. So you're taking into account how the exchange rates are going and then how prices are evolving, relative to major trading partners. That's the one that feeds into our export model and I think that is, typically, among finance ministries and central banks, that is the key metric of competitiveness. But you're absolutely right in the sense that rising rents, rising house prices, do damage the competitiveness of the economy and that was certainly, you know, something we were conscious of.

**Chairman:** Put your supplementary, Senator, and I'll bring you back in again.

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**Senator Sean D. Barrett:** Thank you. No, it's just houses going from 2.5 to up to ten times income and being paid for over 40 years instead of 25 years, that must have affected the competitiveness of the Irish economy. And I think in general, the literature - not just yours - didn't acknowledge that until after the event.

**Mr. John McCarthy:** Not just house prices, but the cost of rents as well.

**Senator Sean D. Barrett:** Yes.

**Mr. John McCarthy:** I think you're right. I think you're right.

**Senator Sean D. Barrett:** Thank you very much. Thank you, Chair.

**Chairman:** Thank you very much. Deputy John Paul Phelan.

**Deputy John Paul Phelan:** Thank you, Chairman, and good morning, Mr. McCarthy. Can I just start with that document just referred to previously by Senator Barrett, Vol. 3, the document that you refer to as not being ... you know, the notes being written on it were not your own? Page 9 of Vol. 3, the executive summary. I'm very good on executive summaries usually myself. On that particular page, the word "boom" has been circled three times by whoever. Now, first of all, can I ask you whose work was this, do you know, at the time? You said it wasn't your own-----

**Mr. John McCarthy:** Am I allowed name names, Chair?

**Deputy John Paul Phelan:** Well, the ... the level-----

**Mr. John McCarthy:** It was the assistant secretary in charge at the time.

**Deputy John Paul Phelan:** Why would you think that the word "boom" was being circled?

**Mr. John McCarthy:** I did consult on this and the feeling was it was a little bit journalistic rather than economic.

**Deputy John Paul Phelan:** Well, that's, I suppose, one way of looking at it.

**Mr. John McCarthy:** That's the information I was given.

**Deputy John Paul Phelan:** Yes. Yes, that's fair enough. I suppose, I want to also refer to another document-----

**Mr. John McCarthy:** Sorry-----

**Chairman:** Mr. McCarthy, yes, go on.

**Mr. John McCarthy:** I mean, if it was up to me, I would have put in "bubble" rather than "boom".

**Deputy John Paul Phelan:** Okay. Vol. 2, page 105, which is a document prepared by yourself for the Tánaiste and Anne Donegan. The second paragraph of that document:

**In summary**, the OECD is forecasting a growth rate of [around] 3 per cent next year, with a slightly stronger pickup than we have assumed in 2009. However, the language regarding Ireland is somewhat 'sensationalist'; we proposed (on a number of occasions) a number of textual changes but these have not been taken on board. The comments on the

property market pre-date the Budget confidence-building measures.

What was the sensationalist language being proposed by the OECD that you were commenting on there, can you recall?

**Mr. John McCarthy:** I can't recall is the simple answer. But I would come back to a point I made earlier on - having dealt with the OECD and participated in meetings for years, every finance ministry will try and get changes to the text. Actually, we do it less than other finance ministries. I have seen finance ministries who will try to rewrite a whole document for the OECD. We will try and maybe nuance the text somewhat - the "boom" being a good example. Sometimes they take them on board, sometimes they don't. To be honest, it doesn't really bother me if something is sensationalist. It is good from an Irish Inc. perspective to have outsiders making comments that may be a little bit provocative, that maybe force us to think, to get rid of the kind of groupthink that we may have.

**Deputy John Paul Phelan:** Was it common for the OECD to use that term "sensationalist" style of language?

**Mr. John McCarthy:** I'm-----

**Deputy John Paul Phelan:** Was it common for them to use ... like, you're ... I'm referring to-----

**Mr. John McCarthy:** Not ... not really, no. No, the OECD would typically be very ... a technocratic type of organisation.

**Deputy John Paul Phelan:** Okay.

**Mr. John McCarthy:** It is ... economists tend to dominate rather than journalists and stuff would, with "boom" language-----

**Deputy John Paul Phelan:** So, was there-----

**Mr. John McCarthy:** But it would be ... it would be technically based and the language would typically be economic.

**Deputy John Paul Phelan:** That's fair enough. The fact that they were using, to use your own term, sensationalist language in this document, was that an attempt by them to ... or was it ... or was it not - I should ... I can't ask a leading question - to highlight that there was pressures building in the Irish economy that should be acted upon?

**Mr. John McCarthy:** Probably, I don't have the text, but in all likelihood, yes. It's autumn 2007, so clearly there were pressures and problems were beginning to manifest themselves at that stage. So in all likelihood ... definitely, yes, that was the case.

**Deputy John Paul Phelan:** I want to refer again in relation to the OECD, to the evidence by Mr. Tom O'Connell, which he gave to the inquiry a few weeks back, and it was in relation to the way OECD and sometimes IMF, but it was specifically OECD country reports were produced. He said:

We would be discussing or interacting with the IMF and the OECD, in particular with the OECD country reports, it was embarrassing. When I used to go to Paris to ... with people to look at the reports, almost every line was parsed and any, anything of a negative

nature needed to be taken out.

Was that your experience too of how those events would happen?

**Mr. John McCarthy:** I wouldn't say everything of a negative nature would need to be taken out. My experience is that some issues might need to be nuanced, so for instance, when in the 2006 report of the OECD, which is the one that talked about house prices and some over-valuation, there was some nuancing of the word but no attempt to change the overall message that the OECD was trying to convey. Remember, it is a report, not compiled by the Irish authorities, but compiled by the economic development and review committee, the so-called EDRC: it is their language. So, if they want to say black is white, they can say it. They have to stand over it but what we can try and do is say, "Well, listen, a better understanding of the Irish economy might involve looking at the wording here, a little bit of nuancing here and there." But I would stress we do not engage in as much of that as a lot of other countries.

**Deputy John Paul Phelan:** Now I want to turn to the ESRI quarterly commentary from the summer of 2007. It was referred to in the Honohan report, I think page 84. Morgan Kelly, in an article which was published in it, argued that most house price surges had ended in a fall of at least 50% in values. Furthermore, he went on to say there had been no quantitative, analytical evidence provided from the Central Bank, I think, at the time and there was a reference made to "The central scenario is, therefore, for a soft landing." I think Senator Barrett has already touched on it. To your recollection, what were the reasons for the Department of Finance in agreeing with the Central Bank in favouring a soft landing scenario for the property market over a hard landing?

**Mr. John McCarthy:** Okay. Well, in a number of documents that we would have sent to the Minister or the Tánaiste at the time, we did outline the central scenario or the baseline scenario of a soft landing, but we did outline the possibility of a hard landing.

**Deputy John Paul Phelan:** It was, kind of, given that there was options for want of a better term. But there was still-----

**Mr. John McCarthy:** On the one hand and on the other hand.

**Deputy John Paul Phelan:** Yes, but the dominant hand, was the soft landing hand.

**Mr. John McCarthy:** Now, the evidence base for a soft landing was ... well, it was along the following lines: there is a soft landing on the prices side, and there is the soft landing on the volume side - volumes, I mean housing output and so forth. Let me deal with the latter first. We made the assumption in various budgetary forecasts, and we modelled a soft landing on the basis of we were currently, or at the time, producing 70,000, 80,000, 90,000 units at the peak. At the time, it was estimated that, on the basis of demographic trends, and on the basis of fall in headship rates, in other words an increase in the percentage of the population who are heads of household, that there was an underlying need for about 50,000 units per annum. Now how do you go from 90,000 to 50,000? Does it fall like that or does it like it fall like that? In the budget documentation, our central scenario was a gradual easing - a fall of about 5,000 or 6,000 units per annum. So, operating over the medium term and converging towards sustainable levels of output. That was the central scenario but we did model internally - in a document that I wrote with a colleague who is now the Secretary General - what would be the implications on the public finances of a hard landing if output was to go from 90,000 down to sustainable levels more rapidly? In fact, it didn't go to sustainable levels, it overshot on the way down, as sometimes

happened. And we concluded that the impact on overall economic activity of each 10,000 reduction would be to shave about a percentage point of the growth rate, add about a percentage point to ... a half or a percentage point, I can't remember, to the unemployment rate, add a half a percentage point to the deficit, and these were simply the first round effects. Clearly, we went from 90,000 to 10,000 in the space of three or-----

**Deputy John Paul Phelan:** On the other end ... on the value end?

**Mr. John McCarthy:** On the prices.

**Deputy John Paul Phelan:** Yes.

**Mr. John McCarthy:** I'll come to that now, Deputy. The evidence for a soft landing ... we took the view that house prices in Ireland had never fallen in nominal terms and data have been collected back as far as 1970. So there was no precedent for this in Ireland. We did have a number of models. So we looked at issues like price earnings ratio, price income ratio, we had an affordability model. So, in other words, the ... when you looked at the growth of employment, the growth of wages, the decline in taxation, the new monetary regime, the portion of disposable income ... of household disposable income that is absorbed by debt payments or debt service costs was in line with the historical norm, about one third. The problem was we didn't realise that these fundamental factors could change so dramatically, that employment would fall by nearly 15%. Now, there is also ... economic theory is also quite consistent with a soft landing in house prices-----

**Deputy John Paul Phelan:** My time is very short now and I have just one more question that I want to get in. Really what I'm asking you, Mr. McCarthy, is, there's very little evidence, from looking at other countries in particular, whether in the European Union or outside of it, to support the soft-landing scenario, and yet ... and I'm talking about the value soft landing scenario, not the reduction in units produced. What evidence did you gather from looking at other countries to support the soft-landing scenario or was there any analytical work done to gather that evidence?

**Mr. John McCarthy:** Yes, yes there was. So if you looked at the situation in Japan, an advanced country ... it's outside Europe but an advanced economy nonetheless. In the period leading up to - I think it's about '91 or '92 - house prices had risen by 180%, ballpark - 100%, remember, is a doubling in house prices ... so, 180%. In the five years after the peak, price levels had fallen by just 15%. That to me would be consistent with a soft landing. Now, Japan subsequently got into a deflationary spiral and prices have subsequently kept going down but five years after the peak, price levels were just 15% below the peak. So there was evidence-----

**Deputy John Paul Phelan:** So was Japan the only example that was looked at?

**Mr. John McCarthy:** It's one example that I looked at. But, certainly, there were examples in which you didn't get that ... I think the Kelly paper looks at 20 or 30 OECD countries where that didn't happen, okay, but-----

**Deputy John Paul Phelan:** Was there enough of that analytical research and comparison done with other countries closer to home maybe than Japan?

**Mr. John McCarthy:** Well, what we were doing was, if you look at the theory behind house prices, and let me ... just bear with me one second here-----

**Deputy John Paul Phelan:** I have a minute and 20 seconds to bear with you and I have one more question that I have ask, so I can't really-----

**Mr. John McCarthy:** Well you asked-----

**Deputy John Paul Phelan:** -----well, if you can be very brief.

**Mr. John McCarthy:** Okay, if you're asking me for the evidence on a soft landing ... I mean, economists think of housing as not just an investment asset but also a consumer good. In other words, it provides consumer services, accommodation and so forth. So unlike a stock in share where if there is overvaluation, it can fall dramatically; in a housing market, if prices begin to fall, people will take the house off the market rather than sell at a loss. So you can get prolonged periods of disequilibrium in the housing market. So, in other words, if the actual prices here, the fundamental prices here, you can get a levelling off and eventually fundamentals catch up. That's the theory and that's the sort of supporting evidence.

**Deputy John Paul Phelan:** And is that what the Department of Finance at the time was-----

**Mr. John McCarthy:** That's what we were, that's what we were thinking.

**Deputy John Paul Phelan:** Okay. I need to turn to one more area, I've a half a minute left. Comments from contributors to the Wright report indicated that there was a lack of leadership and direction in the Department of Finance during 2000 to 2010, and its effectiveness was limited. Would you agree with those comments? And I'd ask you finally what should have been done or is still to be done to improve the Department's role and effectiveness going forward?

**Mr. John McCarthy:** I think the Wright report is quite clear on this. There ... the Department wasn't called upon to lead during that period. The Department was sidelined by the social partnership process, the programme for Government process, all of these had the effect that the Department simply existed to pay the bills. I think that phrase is actually used in the Wright report. The Wright report is also quite clear that the Department took leadership once the crisis kicked in. The Department produced the national recovery plan upon which the programme was based, and it was a very successful programme. The economy is now doing very well on foot of coming out of the programme and so forth. So leadership was shown when it was needed and when the Department was called to lead, when it wasn't sidelined. Sorry, I've forgotten the second part of your question now?

**Deputy John Paul Phelan:** Well, is there anything to be changed in the way the Department is run that, you know, the recommendations for changes in the Wright report that hasn't been implemented or-----

**Mr. John McCarthy:** As far as I know, the vast majority of the recommendations have been implemented. Those that haven't been implemented have been overtaken by events. In other words, the separation of the Department into Finance and the Department of Public Expenditure. So, for instance, the number of economists, a lot of those are now in pair.

**Chairman:** Okay. Thank you very much, Deputy Phelan, and I'll bring you back in the wrap-up again. Just in regard to one matter you were discussing with Deputy Phelan there, Mr. McCarthy, and that was the changes that were made in some of the reports that we've discussed and they were the OECD report wording, "the housing boom is over" changed over to "the housing cycle has turned" and other changes being implemented. Can I put the question to you in regard to the present: are these OECD or IMF reports still being revised before publication

by the Department of Finance?

**Mr. John McCarthy:** Oh, we always get the opportunity to comment on the report.

**Chairman:** Okay.

**Mr. John McCarthy:** Always. And that will always be the case and for every finance ministry in the world that would be the case.

**Chairman:** Okay. And has the tone of the revision or the input into those reports changed? Are you talking things up, talking things down or what is the sort of discourse and narrative that's being placed upon them now?

**Mr. John McCarthy:** The ... from what I've seen, Chairman, is the main changes have been purely of a factual nature, "This figure is wrong, you need to change that." Minor nuances, maybe. I have put in one or two issues myself that have made it more hard-hitting.

**Chairman:** Okay. And on the issue of the modelling for a soft and hard landing, was there any worst-case scenario done in regard to the hard landing?

**Mr. John McCarthy:** Just the document that I referred to earlier on, where we looked at-----

**Chairman:** Which is the 0.5% of unemployment?

**Mr. John McCarthy:** Yes, yes.

**Chairman:** Okay.

**Mr. John McCarthy:** So it was done on the volume side rather than the pricing side.

**Chairman:** There was no ... was there any examination done in regard to ... as we learned subsequently from the Keane report and other issues with regard to the property market, it wasn't just losing employment that put stresses on people's ability to pay for their homes, drops in income, overtime and so forth, which is reflected in the 2009 Central Bank report, when the rules for getting a mortgage were tightened up, where you couldn't include a room-to-let or overtime and so forth? Was the affordability to be able to meet the debt, as opposed to unemployment, ever considered?

**Mr. John McCarthy:** I think a lot of the research in that space has been done by the financial stability team in the Central Bank rather than in the Department of Finance, so we're almost takers of the research. We're aware of the research but I don't think we have done it ourselves.

**Chairman:** No, the Department ... even though the Department of Finance was talking about soft and hard landings, it had no research of its own in this regard?

**Mr. John McCarthy:** Sorry, Deputy, I thought you meant subsequently, when the crisis hit.

**Chairman:** Yes.

**Mr. John McCarthy:** Not ... what I can say definitively is not on the economic side of the Department. I'm not aware of research that may have been done on the other, on the banking and financial side.

**Chairman:** No, but on the hard landing, on the soft and hard landing theory, was there research carried out by the Department of Finance on the hard landing theory?

**Mr. John McCarthy:** Just, just on the volumes issue----

**Chairman:** Just one model, which was on the 0.5% tied to construction-----

**Mr. John McCarthy:** Yes, yes-----

**Chairman:** Nothing around affordability, nothing with regard to what Senator Barrett was talking about, people on 40-year mortgages - the difference being that, on a 20-year schedule, once kids would be going to college the mortgage would be cheap, you know on a 40-year mortgage, you are still in the middle of your mortgage and your kids going to college - all these affordability things; drops in overtime allowances, and other factors, affordability measurements as opposed to unemployment, anything done like that?

**Mr. John McCarthy:** We had an affordability model with all those factors factored in, okay, but we didn't shock the model, so to speak; in other words, if employment fell by 20%, what would be the impact on affordability? No is the answer.

**Chairman:** And, any realisation between that the Irish economy was 24% into construction, and this was twice above the European norm, that an impact upon construction in this country would be twice what it would be in the European norm, and you were looking at the European norm as your template with regard to the hard and soft landings. So, was that not a bit of an incongruence that construction in this country was twice above what it was in the European norm, but you were looking at European norm models instead of landings?

**Mr. John McCarthy:** We certainly should have modelled it, absolutely, we certainly should.

**Chairman:** Right. Deputy Pearse Doherty.

**Deputy Pearse Doherty:** Go raibh maith agat, a Chathaoirligh, agus fáilte, John. Can I ask you, in your opening statement, you agreed that the staffing numbers of economists in the Department was inadequate. You also mentioned that there was, there has been, and continues to be, efforts to address this. You also, and you've given some figures to the Deputies, or the Senators, in relation to that. Could you outline your opinion on how, and in what areas of your division, this inadequate number mainly impacted on the work of the Department?

**Mr. John McCarthy:** Are you referring to my opening statement or the witness statement?

**Deputy Pearse Doherty:** Well, the fact that you, yes, your statement that there were an inadequate number of economists. So how did it affect the work of your Department?

**Mr. John McCarthy:** There's an important issue here, which I think you're raising. To me, there is no correlation between the number of economists and the quality of policy-making on the one hand, or the number of economists and the ability to foresee the crisis. Let me give you a couple of examples, Deputy. The IMF, an organisation that I have huge respect for, employs hundreds, if not thousands of economists, and they did not foresee the crisis coming. So, in 2008, when we brought forward the budget, we based it on the IMF's forecasts, which were published at the beginning of October. The budget was then in mid-October. A week or so afterwards, the IMF revised its forecasts, so even though there was all of these economists, it simply was not possible to foresee the crisis. The number of economists and the quality of policy-making: the ECB, not an institution I have particular affection for. This was an institution that currently employs thousands of economists, and actually tightened monetary policy in 2008 and 2011 - absolute policy mistakes. So I just wanted to get across the point that it's not

necessarily the number, but, having said that-----

**Deputy Pearse Doherty:** Are you saying that the number wouldn't have made a difference?

**Mr. John McCarthy:** I think it would have made a difference in some respects but not in others. If we had 100 economists we still would not have foreseen the global crisis, but what we could have done, Deputy, is we could have allocated more resources to looking at where the imbalances were really becoming problematic. Where the Chair mentioned, we could have shocked the property model, the construction model, to see, but we simply didn't have the resources to do that.

**Deputy Pearse Doherty:** There has been evidence given to the committee that it's about the framework used in modern macroeconomics that was at fault here, and there's been suggestions that no matter how many economists you had in the Department, there was a bit of herd mentality there. Do you subscribe to that notion, that-----

**Mr. John McCarthy:** I do, I certainly do. In my witness statement, which is why I asked where ... I do refer to the fact that the economics profession failed. And I think it failed in a number of aspects. I list them there - it's general ability to foresee the crisis ... sorry, it's on page 4 ... to even acknowledge that cataclysmic events were possible in a market economy. There was a general herd mentality, to use your own phrase; there was a general herd mentality on 'the Great Moderation'. There was a belief that the business cycle had been permanently tamed - clearly wasn't the case - and there was also a failure to understand the linkages between the real economy and the financial sector.

**Deputy Pearse Doherty:** But some people ... some people were calling ... like, for example, in your opinion now today, do you believe that Morgan Kelly was correct in his analysis?

**Mr. John McCarthy:** I think Morgan Kelly's analysis ... well, I mean, there was a 50% fall in nominal house prices. I think he said between 40% and 60%, so he is correct. I think where his ... where his model was innovative was in the sense that we were looking at our own models - and I mention price earnings ratios, the affordability model - others were looking at the so-called residual-type approaches. So you look at actual house prices and then you look at house prices when they're modelled on the basis of the driving forces ... the fundamentals.

**Deputy Pearse Doherty:** What about the details of how you were looking at it and how he was looking at it in terms of ... in terms of summing it up and not agreeing with everything but do you believe on the ... on the ... in fairness that his was mostly correct in relation to his analysis while the analysis of the Department and the team of economists that you had failed to see what he was ... what he was seeing in his paper?

**Mr. John McCarthy:** We didn't look at it the way he did and it was an innovative approach and it was a very useful approach.

**Deputy Pearse Doherty:** But can I ask you ... can you give the committee any examples where economic policy was changed as a direct result of a critical report from the Department's economic division and also can I ask you to give an example where your own analysis differed from the consensus view? Did you yourself offer - and I'm not just talking about a number of years ago ... today or in the last number of years - offer contrarian views and were these taken on board?

## NEXUS PHASE

**Mr. John McCarthy:** I would stress on that, that during the bubble years I was very much at the technical level. I sent in the org charts to the committee. My job between 2003 and up to 2006 was analysing consumer price inflation and competitiveness. So it wasn't to advise on fiscal policy and so forth. From the end of 2006 into 2007, I assumed overall responsibility then for the macroeconomic forecasts. So an important distinction needs to be made between the technical level job, where you're modelling inflation, you're modelling competitiveness and so forth, and my job today, which is closer to the policy space, where anything that affects the economy, I advise the Minister on. Back in 2006, I advised on price dynamics and competitiveness.

**Deputy Pearse Doherty:** But, Mr. McCarthy, we know from-----

**Chairman:** Question now, Deputy.

**Deputy Pearse Doherty:** It's on the same question ... but we know from people, for example, Marie Mackle, who was answering parliamentary questions ... and she wasn't in the position that you were in but she was offering a contrarian view. The question I have ... and to go back to the question is: can you give an example to the committee, right up until now, where economic policy was changed as a direct result of a report from the Department's economic division and can you also give an example to the committee, if you yourself offered any contrarian views to the consensus during the bubble period and up until now, and were those taken on board?

**Chairman:** And just maybe if you could refer to the two specific questions that Deputy Doherty has made and then I can move on, please, Mr. McCarthy. Deal specifically with them rather than generally.

**Mr. John McCarthy:** Okay. I think it needs to be remembered that the economics function was very, very small in the overall Department. Our job was simply to produce the forecasts. People did not come to the economics division to ask, "Should we do this policy or should we not?" Our role was simply to produce the forecasts at the time. That is no longer the case, where we are consulted on wider policy issues. So you cannot have a situation in which there is a change in policy because the economics division is consulted-----

**Chairman:** Processes here ... sorry, Mr. McCarthy, we're getting into processes here. That's not what Deputy Doherty asked you. He asked you in situations where an editorial position was taken and also asked you in situations where you may have contrarian views yourself. So can you deal with those two matters-----

**Deputy Pearse Doherty:** Perhaps give examples where an example where economic policy was changed as a direct result of a critical report from the Department's economic division, that's the first part of the question. The second part was an example of where your analysis differed from the consensus view. Was that offered and was it ever taken on board? Examples-----

**Chairman:** I don't want to be repeating myself-----

**Deputy Pearse Doherty:** And if there was never one, then let's just state that. If there was, give examples.

**Chairman:** This is going to be answered. We'll be here all around the house if we need to but I'm going to be very direct with you on this, Mr. McCarthy, and answer the questions directly, please. I don't want to be going into processes, okay?

**Mr. John McCarthy:** I cannot recall a situation in which a policy was changed on foot of the macroeconomic forecasts. I did not have contrarian views.

**Chairman:** Okay, thank you very much. Deputy ... Senator, sorry, Senator Marc MacSharry.

**Senator Marc MacSharry:** Thanks. As early ... welcome. As early as 2001, a paper presented in the MAC meeting on 26 April shows that the Department was facing a specific skills challenge and had a broad spectrum of skills requirements, amongst others, in economic modelling. Can you give us your opinion if efforts made by the Department were insufficient after 2001 to further improve the skills level in there?

**Mr. John McCarthy:** Yes. After 2001, the Department approached the Central Bank and the ESRI to second somebody to the Department to undertake technical work on their behalf. I moved from the Central Bank to the Department at the time and a senior economist from the ESRI moved. We undertook some of the technical work. So, in other words, the economic capacity or the modelling capacity was improved.

**Senator Marc MacSharry:** Okay. Just following on from what Deputy Doherty had asked you there about you giving an example of a policy change as a result of advices coming from the economic division, can you give us an example - and perhaps the one the most relevant to our work here in the inquiry - of advices coming from your division being specifically suppressed and ignored by Government to the detriment of what played out?

**Mr. John McCarthy:** Well, let me reverse slightly what I said to ... to Deputy Donnelly in the sense that contrarian views-----

**Chairman:** Deputy Doherty.

**Mr. John McCarthy:** Who did I say?

**Chairman:** Deputy Donnelly.

**Mr. John McCarthy:** Apologies to Deputy Doherty. In various publications, the stability programmes and so forth, if you look at the economic text there, we were the contrarians because we were saying that fiscal policy is inappropriate, we were saying that there is an over dependence on construction, we were saying that there is a loss in competitiveness that needs to be addressed. That was coming from the economic division. Did the Government act on it? Well, to be fair, the Minister signed off on the budget strategy memorandum each year. So he agreed with a more prudent fiscal stance. That's typically June or July. Unfortunately, later on in the year that process was overtaken by events. So what was agreed initially and what was brought to Cabinet early in the summer was subsequently taken over by events and policy became-----

**Senator Marc MacSharry:** You are talking about 2006 here, are you?

**Mr. John McCarthy:** I'm talking right the way through 2001 probably right through to 2006-07.

**Senator Marc MacSharry:** So where can we, these ... this is documented where? The-----

**Mr. John McCarthy:** This is documented in a chart in the Wright report, where it shows the level of spending that should have been put forward and then the actual amount that was agreed in the budget. And there's a massive gap between both.

**Senator Marc MacSharry:** Yes ... no, no, we know that. So the economics ... what you are saying is that the economics division within the Department was saying since 2001, you know, “Cool the economy, go counter-cyclical on policy ... on fiscal policy.” Is that your position?

**Mr. John McCarthy:** It’s ... yes, but with one caveat. It wasn’t an economics division on its own at the time. It was the budget and economic division. So it was the co-ordinated view of the budget and economic division.

**Senator Marc MacSharry:** So you’re ... so is it ... is what you’re saying that those responsible for budgeting and economic analysis and policy within the Department were saying to cool the economy and introduce counter-cyclical policies from 2001 on and that Government of the days ignored that advice?

**Mr. John McCarthy:** The Minister didn’t ignore it in the sense that he signed off on the budget strategy memorandum - and this is detailed in the Wright report - each June or July. But between then and when the budget ... in early December, other events took over that allowed a more pro-cyclical fiscal stance.

**Senator Marc MacSharry:** All right. So just so we are clear now, you’re saying that at the beginning of your process, which was earlier in the year, you would sign off and you would say “Look, we want you to go more counter-cyclical.” Are you saying that the situation improved then, which allowed the Minister to take a pro-cyclical approach, or are you saying that your advice remained, so that these circumstances taking over ... I mean, did circumstances take over for the better so that your advice had become obsolete or was it the case that your advice was ignored and, albeit having signed off on it, the Minister of the day decided to go pro-cyclical despite what he had signed off on?

**Mr. John McCarthy:** I can’t answer definitively because I wouldn’t have been as close to the political space as I am now. But I will give you my suspicion and I think it’s probably a combination of both. I think you had these other processes at play but also you had massive surges in tax revenue in the second half of the year which, typically, when corporate taxes come in and so forth ... which some would see ... if you get the tax revenue coming in, maybe you can spend a bit more and so forth.

**Chairman:** Okay. Finish up, Senator.

**Senator Marc MacSharry:** Yes, just on a separate issues, but briefly. You mentioned earlier about people above your pay grade, is how you put it, would tell you, “Take that out, don’t say this, we can’t say the other”, I think, were in or around what you were saying. In your ... in your time in the Department, was dissent discouraged to the point that it could hamper one’s career progression in the Department?

**Mr. John McCarthy:** Not ... not really would be my ... my ... I mean, there was a kind of departmental view that policy was moving in the right direction. Most people bought into that. Some were more vocal than others. So I think there was a consensus within the Department that there ... there were problems but we simply weren’t being listened to. There was ... it was a case of the ... the boy who cried wolf, really. We were talking about risks, these risks never materialised so we could almost be ignored.

**Chairman:** Thank you very much. Senator Michael D’Arcy.

**Senator Michael D’Arcy:** Chair. “The risks never materialised”, but they did materialise.

**Mr. John McCarthy:** Yes, but not until 2007.

**Senator Michael D’Arcy:** Yes, but they did materialise in 2007.

**Mr. John McCarthy:** After 2007.

**Senator Michael D’Arcy:** And do you think you or the Department were strong enough?

**Mr. John McCarthy:** No, no. We should have ... we should have - and I acknowledged this at the beginning and it’s acknowledged in the Wright report - we should have articulated our views more strongly. But at the end of the day, we advise; we are not the decision maker.

**Chairman:** Senator, I’m picking up ... just ... maybe it’s not coming from your space directly but somewhere in proximity to you there is some phone distortion there coming off.

**Senator Michael D’Arcy:** Do you feel that the Department were kept up to speed by the Central Bank and the regulator’s office sufficiently about financial stability? Did you have enough information?

**Mr. John McCarthy:** I can’t comment. I wasn’t in the division in the Department that dealt with the Financial Regulator. I dealt with the economics division of the Central Bank and our discussions focused almost exclusively on short-term and sometimes medium-term macroeconomic prospects. I did not give and don’t know anybody ... or didn’t know anybody at the time in the Financial Regulator.

**Senator Michael D’Arcy:** And in terms of the Central Bank information flow between the Central Bank and yourselves, was that sufficient in relation to financial stability matters?

**Mr. John McCarthy:** The ... the division of labour within the ... the central banking system is ... was that the regulator looked after micro-prudential and the Central Bank looked after macro-prudential regulation. The Central Bank team that dealt with macro-prudential regulation dealt with a separate division the banking and finance division, I think it’s called, within our Department. We did not deal with those guys. We dealt with ... as I said, our job was forecasting the economy so I talked to people in the Central Bank who are forecasting the economy.

**Senator Michael D’Arcy:** Okay. Did you have sight of the SR ... FSR reports from the Central Bank?

**Mr. John McCarthy:** I would have seen one or two of them. I would have been asked to comment on the macroeconomic outlook. I think maybe the first page or even the first paragraph might briefly go into what the short term outlook was. I would not have looked at issues ... you know, bank capital or anything like that.

**Senator Michael D’Arcy:** Can I ask your view in relation to the level of indebtedness outlined in those reports? I think 2004 was the first period when they outlined a 71% level of indebtedness in relation to GDP, climbing to the 2007, the final FSR report, to 248%. In terms of financial stability did anybody in the Department of Finance consider that that was a concern?

**Mr. John McCarthy:** I understand my colleagues in the banking and finance division were concerned about those issues. I do know - when the Central Bank raised it in one of their quarterly reports, so not the financial stability report - we did have a line, a speaking point or ... or a line in a note we did for the Minister, saying that they were concerned, sorry that we, the Department were sharing the concern of the bank regarding the level of - I think it’s household

indebtedness you're referring to Senator rather than public or NFC indebtedness - that the Minister and that the Government shared the concern and that it was incumbent upon the banks to lend prudently and to take into account the fact that interest rates could change and so forth. It's in one of the documents here, if you bear with me I'll be able to find it but-----

**Senator Michael D'Arcy:** You don't really-----

**Mr. John McCarthy:** -----it's in there.

**Senator Michael D'Arcy:** I suppose what I'm trying to scope, Mr. McCarthy, is ... what you ... what the Department did about it apart from a line?

**Mr. John McCarthy:** Well I mean-----

**Senator Michael D'Arcy:** To put it into context, we went from a very, very low level of household indebtedness to the highest in Europe - 248% of GNP according to the final FSR report. What did the Department do in relation to that matter specifically? Can you itemise anything that was done from the economics section?

**Mr. John McCarthy:** I think we have the third highest level of household indebtedness in Europe. Denmark and maybe the Netherlands are higher but that's ... the point is it's still very, very high. I'm not aware that the Department could do anything about it but it would be ... if anything was to be done it would be colleagues on the banking and finance side who look after credit growth. This was not on the economic ... the short-term and medium-term economic forecasting side of the house. Credit growth and indebtedness don't feature in our short-term models.

**Senator Michael D'Arcy:** But would it not surely ... I'm not allowed use the word "surely" I believe, sorry, could it not have been a danger to the financial stability of the banks-----

**Mr. John McCarthy:** Absolutely ... I mean if-----

**Senator Michael D'Arcy:** -----overall, overall? Would that not impact upon the macro-economic perspective?

**Mr. John McCarthy:** Had I been the chief economist at that stage, or had I been at a higher level, I would have been encouraging-----

**Senator Michael D'Arcy:** Sorry, can I just-----

**Mr. John McCarthy:** -----macro-prudential tools to be brought in.

**Senator Michael D'Arcy:** I'm not asking you about you being chief economist at that stage, I'm asking for your view of what the Department of Finance did in relation to that level of growth.

**Mr. John McCarthy:** Subject to being corrected by somebody else, I'm not aware that the Department did anything about that level of credit growth.

**Senator Michael D'Arcy:** Thank you.

**Chairman:** Thank you very much, Senator. Deputy Michael McGrath.

**Deputy Michael McGrath:** Thank you very much, Chair, you are very welcome Mr. Mc-

Carthy. Can I start by asking you, after 2004, the IMF, OECD and ECOFIN all clearly recommended a tighter fiscal stance and the building up of a cushion for the time when income from property related transactions would fall. Can you discuss why, in your opinion, the Central Bank's recommendations in Ireland, to the Minister, did not more forcibly highlight this issue?

**Mr. John McCarthy:** Can I just be clear, Deputy, you are asking why the Central Bank was not more forceful in its recommendations on fiscal policy? Is that-----

**Deputy Michael McGrath:** Yes, and linked in to the issue of, you know, a property collapse and the impact that would have on Exchequer finances.

**Mr. John McCarthy:** I think, to be fair to the bank, they did raise the issue of the procyclicality of fiscal policy on many occasions in the various quarterly bulletins. I know there is another process whereby the Governor of the Central Bank sends a letter to the Minister in advance of the budget, it's essentially a pre-budget submission, and typically warns about the need for fiscal policy to be countercyclical and not add to the overheating of the economy. Maybe those ... maybe the bank's comments could have been a little bit harder hitting. In fact, it would have helped us in the Department if they were harder hitting but I would have to go back and check and see exactly what they said. But I'm certainly conscious that in many of the bulletins they would have raised the inappropriateness of fiscal policy at the time.

**Deputy Michael McGrath:** Sure. Can I raise the issue of the structural budget balance, or the cyclical balance as such, and you say on page 8 of your witness statement, "Measures of the underlying balance (the so-called structural balance [...] did not raise any red-flags either." And you're referring to the pre-crisis period presumably. So, can you just clarify for the inquiry, who measured the structural balance, was there a common methodology across Europe, for example, and what kind of figures were being reported for Ireland in, say 2006-2007, for structural balance?

**Mr. John McCarthy:** I think, Deputy, this is a very, very pertinent question. Because if you look back, not just in real time - in other words in 2003, looking at the position in 2003 - but if you look now, going back, and I've spoken a bit at a Bruegel conference at the tail-end of last year, it shows that we were compliant with the requirements of the preventive arm of the Stability and Growth Pact. We were running, I think it's every year, bar one, structural surpluses. So, we were overachieving our medium-term budgetary objective. So there was no-----

**Deputy Michael McGrath:** Who measured this structural surplus, just to be clear, who measured it?

**Mr. John McCarthy:** Who measures? What is done there, Deputy, is twofold. There is a harmonised methodology that is applied across all member states. It is a huge problem for Ireland, for Slovenia, for small member states it is a huge problem. This is a methodology that is designed to fit France and Germany. Unfortunately, it is a one-size-fits-all approach. It does not work for Ireland and I can say that quite definitively.

**Deputy Michael McGrath:** Even today?

**Mr. John McCarthy:** Even today. It gives counter-intuitive results in many instances. Let me give you an example, if I can. So, in theory, and for a large country like Germany or France, the change in the structural balance is tantamount to the fiscal effort. So, in other words, if the fiscal ... if the structural balance deteriorates by 1% of GDP, that's equivalent to a fiscal stimulus. So, in Ireland we consolidated since the crisis kicked in by 17% of GDP, whereas the

change in a structural balance over that period is about 6%. So, it gives a completely misleading picture of the fiscal stance in Ireland, even today. There have been some minor improvements to the methodology but they are not game changers.

One of the inputs here is trying to measure the business cycle, so when a large country had a big problem estimating what's called the NAIRU, changes were agreed. We've been raising issues for years, almost ignored, except this year when we did raise an issue regarding the so-called expenditure benchmark. Now, can I just, I'm sorry for eating into your time, recognising the shortcomings of the structural balance, the so-called six pack - about two of the regulations refer to the Stability and Growth Pact the others are for the macro imbalances procedure - introduced the concept of an expenditure rule, the so-called expenditure benchmark, which is a little bit easier to measure because it smooths potential output over a ten-year horizon looking at just year-to-year changes. So it's a little bit better but it's not the be all and end all. It's ... this issue is still a problem for Ireland.

**Deputy Michael McGrath:** So can I just put it to you, Mr. McCarthy, one of the key observations or criticisms that is made is that during the pre-crisis years, while Ireland was reporting, you know, budget surpluses in headline terms, that in reality when you strip out the cyclical tax revenues that there was a major structural deficit there as such. But are you saying that Ireland was actually complying with the structural balance requirements from Europe at the time, in accordance with how the structural balance was measured in harmonised terms during all of those years?

**Mr. John McCarthy:** Yes.

**Deputy Michael McGrath:** Yes?

**Mr. John McCarthy:** Yes, it's a huge problem and yes that's exactly what I'm saying.

**Deputy Michael McGrath:** Okay, thank you.

**Chairman:** Thank you. Just on that point, Mr. McCarthy-----

**Mr. John McCarthy:** In one year we didn't, but by and large over the 2000 to 2007 period, yes, Deputy.

**Chairman:** On that point specifically, in the Regling and Watson report, which I assume you're familiar with, I'll just quote the specific paragraph that relates to that under heading D: The Fiscal Stance:

For a long time Ireland's overall fiscal policy was considered to be exemplary because the country achieved fiscal surpluses every year from the mid-90s to 2006, including the creation of a Pension Reserve Fund to make budget surpluses politically more acceptable. However, the nominal budget figures mask and underlying deterioration in the fiscal situation after 1999.

So, in Regling and Watson, they're saying that there is a faultline in the Irish economy going right back into the 90s. Why was that there and how was it not identified by people like yourself whose job would have been to examine, in micro-detail, the economic structure of the Irish economy?

**Mr. John McCarthy:** The answer is quite simple. We are legally bound ... legally, it's in the treaties, to apply ... it's not in the ... there's a gentleman's agreement among Ministers that, I

think, was signed off in 2001, 2002. But it stems from a legal provision, from a regulation, that there is a harmonised approach that applies to all member states. So, we can produce whatever measure we like, but when it comes to assessing compliance with the pact, the Commission will apply the one-size-fits-all policy. That's where the faultline lies.

**Chairman:** Mr. McCarthy, there's an anomalous situation in Ireland where country boreens in the west of Ireland have a speed limit of 100 km/h on them, but you don't drive 100 km/h on those country boreens because it's quite dangerous. Just because the sign says you can drive at 100 km/h, you don't do it. Likewise, when there are rules like this, and you identify difficulties, you don't proceed exactly to the letter of the rule. And that's the question I'm asking you. Was this difficulty identified and was anything actually done about it?

**Mr. John McCarthy:** Yes, the difficulty ... we highlighted ... if you look, Chairman, at the stability programme update in 2003, I think it was, we go into great detail outlining the shortcomings of the approach to Ireland. We have made a number of submissions to DG ECOFIN, the economics Ministry in the Commission, including as recently as, I think it was, March, April of this year, in which we produced, myself and a colleague, a detailed critique of the expenditure rule. And the Commission actually said, for the first time that I can remember, "Actually, Ireland has a point. We are unilaterally changing the approach to calculating the expenditure benchmark." That did not apply for all the years we have been saying, "This doesn't work for Ireland", we were ignored. It was one-size-fits-all, but we have made progress this year.

**Chairman:** Deputy Joe Higgins.

**Deputy Joe Higgins:** Mr. McCarthy, I'll just quote a paragraph from Nyberg's report, IV. You don't really need to see it on the screen:

The Commission [Nyberg's commission] considers that this pervasive pressure for consensus may explain why so many different parties in Ireland simultaneously were willing to adopt specific policies and accepted practices that later proved unsound. At the same time, the apparent consensus of banks and authorities around the view that markets remained sound and prospects remained positive gave further comfort to both. A number of banks essentially appear to have followed the example of peer banks in a "herding" fashion; there is little evidence of original critical analysis of the advantages and risks of the policies. Widespread lack of critical discussion within many banks and authorities indicates a tendency to "groupthink"; serious consideration of alternatives appears to be modest or absent.

Now, when you moved, or you were in the Department through the whole of the 2000s, and then you moved to the macroeconomic responsibilities in 2006, I think. So, to what extent was this pressure felt and absorbed, or not, inside the Department, in your own experience?

**Mr. John McCarthy:** Well I mean, I think Nyberg is right there, there was a ... there was an element of groupthink; there was a kind of a consensus, it has to be said, on where the economy was going, and I wouldn't dispute any of that. Yes, the paragraph you read, Deputy, refers quite a lot to banks. I simply couldn't-----

**Deputy Joe Higgins:** -----authorities as well, which-----

**Mr. John McCarthy:** Yes, absolutely ... and I'm commenting on one part of the authorities. I couldn't comment on the banks but, to me, it seems logical.

**Deputy Joe Higgins:** Yes. Now, the ... occasionally hard landing scenarios were mooted,

Central Bank and various reports, but was there any time that anything, other than a soft landing, was seriously entertained as a range of ... or, as a possible serious option?

**Mr. John McCarthy:** Yes, and I come back to the report - it's in one of the core documents - where myself and the current Secretary General did a detailed piece of economic analysis on what the impact would be of a fall in the level of economic activity in the housing market. We did not ... to be fair, we did not read across to what the implications were for financial stability. It wasn't our job at the time.

**Deputy Joe Higgins:** But that did not move up then to the final views that were dominating policy-making, etc.

**Mr. John McCarthy:** No, I mean, the approach that we take is similar to what would be done in most finance Ministries. We produce a model forecast, a central scenario, the most likely outcome, but then we look at various scenarios around that, upside risks, downside risks, and we model some of those. So we modelled the hard landing, if output was to fall more rapidly than assumed. We did that and we came up with results that ... I think the ESRI published a paper around the same time and they were very, very similar results.

**Deputy Joe Higgins:** And, Mr. McCarthy, in this remarkable consensus that developed, as Nyberg stated, which included the regulator authorities and Department, indeed, just ask yourself, was the predominance among establishment circles, nationally and internationally, of neoliberal economic ideology, and, as Nyberg put it, "the paradigm of efficient markets" ... was that a big factor in that consensus that was so universal?

**Mr. John McCarthy:** I think it was, Deputy. I think ... and to give you a specific example, I think the models that we had, I'm talking here about, for forecasting purposes, were not dissimilar from models that other treasuries would have, that other central banks would have. In fact, a couple of years ago the fiscal advisory council, as part of their mandate, looked at our forecasting model and concluded it was in line with best practice. But where it failed, and where other models failed, was in one particular area, and that was they did not incorporate the impact of the financial sector onto the real economy. The real economy, I mean, production, output, employment and so forth, and-----

**Deputy Joe Higgins:** Just to-----

**Mr. John McCarthy:** -----and, just ... sorry, if I could, just, Deputy, the assumption at the time was that, within financial markets, you had this efficiency markets hypothesis, which I think you referred to. The assumption was that markets were fully efficient, that the cost of capital was simply the policy rate plus a term premium, a liquidity premium, and so forth, and once you had the price or the cost of capital, financial intermediation then brought savers and investors together and everything was kosher. That was proved to be incorrect.

**Deputy Joe Higgins:** Let me just pursue that a little bit further, Mr. McCarthy. In your opening statement you say economists failed "to acknowledge that cataclysmic breakdowns in a market economy were indeed possible" and "in the widespread assumption that the business cycle had been permanently tamed". Now, presumably, going through college, economists learn, for example, some of the basic ideas of Karl Marx, who 170 years ago told us how inherent in capitalism was the boom and slump scenario, and explained it in detail. And also, we had the experience, as you said, of Morgan Kelly's study of about 30 boom and slumps, and particularly-----

**Chairman:** Final question, Deputy. This is it.

**Deputy Joe Higgins:** -----particularly the Scandinavian one in the 80s and 90s. Is it remarkable that none of that found its way into the consciousness of the Department, the Central Bank, the regulators, as a huge risk considering the bubble that everybody saw?

**Mr. John McCarthy:** I don't think the Department, Central Bank, and regulator, have a monopoly on failing to see that. I mentioned before there, the IMF. I could tell you every finance Ministry, every central bank ... my own job as the forecaster, I would participate at European Commission meetings, where all 28 member states would be discussing forecasts at an OECD level. Everybody failed to see this. There was this "Great Moderation" as it's called. Inflation had been tamed. In the past you had ... here's your trend growth rate and GDP, you know, fluctuates around that whereas it was now more like that, so this was the "Great Moderation". I think it was the economist Hyman Minsky who famously said that stability breeds instability. I think that was part of the problem here. We had years and years and years of stability, so people assumed there was this new paradigm, this "Great Moderation", and the models couldn't capture financial disruption. So models themselves failed, although I always think it's the users of the models rather than the models themselves. But what we are doing is trying to develop a model that better incorporates the financial sector into the real economy, how the ... how financial disruption can be brought across into output and employment and so forth. So this is being done in conjunction with the ESRI and I have a PhD economist working on my team, working on that, currently completing a PhD and working with the ESRI on it.

**Chairman:** Deputy Kieran O'Donnell.

**Deputy Kieran O'Donnell:** Mr. McCarthy, in 2005-06, the Minister was advised that the country was, depending ... the Minister for Finance ... depending on unsustainable tax revenues. How robustly was the Minister challenged on the tax and spending policies implemented, and what contingency plans were put in place by the Department to deal with the problems which were envisaged? And I note you've made references to it already. You prepared a report in May 2005 around the whole issue of housing where you looked at 10,000 decline and the impact that would have. If you would just answer the question in that context and did you look at worst-case and best-case scenarios rather than just looking at incrementals of 10,000 units?

**Mr. John McCarthy:** I think what the paper says, each 10,000 units ... So I think we do go into if you went from 90 down to 50, which was, at the time, the estimated sustainable level of output, what the impact would be. The Minister was informed-----

**Deputy Kieran O'Donnell:** David Doyle in his interview to the Wright report, the then General Secretary, this was the basis of this comment. You might ... Just to continue, sorry.

**Mr. John McCarthy:** We did in various publications, and I assume my colleagues on the fiscal side also, did outline that there was a substantial narrowing of the tax base, that you were cutting income tax and so forth and that this was being replaced by transitory revenue from, you know, stamp duties, capital gains tax and-----

**Deputy Kieran O'Donnell:** Did you look for, in your role as an economist in the Department ... did you look for ... that the tax incentive schemes around housing ... the various tax incentive schemes, that they would be discontinued earlier? They were due to finish at the end of 2004; they didn't finish until July 2008. Did you specifically in your role as an economist in the Department look that they should be discontinued?

**Mr. John McCarthy:** No, I was looking at inflation and competitiveness.

**Deputy Kieran O'Donnell:** But you did a report on housing.

**Mr. John McCarthy:** I was asked to do that because, at the time, I was moving across into looking at the macroeconomic forecasts so what-----

**Deputy Kieran O'Donnell:** You did a report specifically on housing.

**Mr. John McCarthy:** On housing and housing feeds into forecasts.

**Deputy Kieran O'Donnell:** And being, we'll say, a highly experienced and professional economist, would you not ... did it not arise that as part of that review you suddenly said, "One of the elements here has been how the tax policy by Government has driven house completions?"

**Mr. John McCarthy:** Colleagues on the tax side were advising along those lines. It's not my job to look at their area. They were advising along those lines.

**Deputy Kieran O'Donnell:** Were you operating in silos in the Department?

**Mr. John McCarthy:** I think that's acknowledged in the various reports. In fact, it is acknowledged in the various reports.

**Deputy Kieran O'Donnell:** You were all operating in the same building.

**Mr. John McCarthy:** Yes. Sorry, not the same building. There were a few buildings. But, yes, it is quite clear. I do not know whether it's the Nyberg-----

**Chairman:** Try not to be leading if you can. Just ask the question.

**Deputy Kieran O'Donnell:** The question I'm asking is someone looking in with the Department of Finance, with various elements that they should have been integrated, how do you come up with a cohesive policy within a Department without sections of the Department not discussing specific aspects of policy with each other?

**Mr. John McCarthy:** It is quite clear and I don't know whether it's the Nyberg or it is the Wright report, that there was a silo-based culture at the time, that no longer exists. We now have various governance changes and procedural changes, whereby all policies are discussed every fortnightly by what is called our policy committee. All staff members in the Department are encouraged to bring issues to the policy committee and every division in the Department is represented but, at the time, there was a silo-based culture.

**Deputy Kieran O'Donnell:** Was there any encouragement for people to come forward within the Department at the time, either from top, we'll say, general secretary level down or Ministers, for people to come forward with contrarian views or views that were left of field?

**Mr. John McCarthy:** Every year each division in the Department would tog out in front of our management advisory committee and everyone could bring whatever issue they wanted to the table, so any contrarian views, they could have expressed them there.

**Deputy Kieran O'Donnell:** Can I just move on very quickly? You made reference to the OECD report and it's Vol. 3, Chairman, and I just want to make reference to a couple of areas. Who pays for the OECD report?

**Mr. John McCarthy:** We make a contribution to the OECD. I think it's done through the Department of Foreign Affairs.

**Deputy Kieran O'Donnell:** So it's the Government pay for it.

**Mr. John McCarthy:** Yes, I mean, all governments fund the OECD.

**Deputy Kieran O'Donnell:** Now in the report-----

**Chairman:** Can we have the page numbers there, please, Deputy?

**Deputy Kieran O'Donnell:** The page numbers are page 9. I want to make reference, Chairman, to the draft report that was provided to the Department and then to the final report that was published. The draft report runs from page 9 to page 20 and the final report runs from page 23 up to page 37, but I've only two quick specific references. This report was ... the OECD came and did an on-site inspection on 20 February 2008 which was seven months before the night of the guarantee, per the report. They say on page 25, "The economic situation and policies were reviewed by the committee in February 2008 and they were approved then on 5 March 2008." The question I want to ask is there's wholesale changes within the two reports. The word "boom" suddenly becomes "buoyancy", which is a very different connotation. Two specific areas I want to look at are page 9 on the draft report, Chairman, which specifically deals with "financial stability risks remain". And the relevant page on the revision is page 26. Now that read, "financial stability risks remain"; when it came to the final report it went, "containing risk to the financial system" so they changed that. And there's one specific reference that I want to make reference to, Chairman. It says-----

**Chairman:** I need to push you to a question now, Deputy, because you're going to run out of time.

**Deputy Kieran O'Donnell:** I want to ask why these changed, and they are specifically around the banks, "...while some features of the deposit insurance scheme should be reconsidered and a special swift procedure for closing failed banks should be enacted". That is completely deleted from the final report in page 26 and equally, Chairman, page 12 deals with a section then where it speaks around in the context, sorry, it says:

Payouts from the bank deposit insurance scheme should be available more rapidly and the scheme better funded to reduce liquidity concerns in case a bank comes under pressure. Enacting an insolvency process specifically adapted to banks should also be considered.

That's on page 30 of the final report.

**Chairman:** I've afforded you a bit of time now, Deputy, but I do have to push you to a question.

**Deputy Kieran O'Donnell:** It's completely deleted. So those two issues which are to do with the liquidity of the banks, to do with putting in place a special swift procedure for closing failed banks, which is a resolution mechanism and, secondly, about insolvency legislation being enacted for banks, they are completely deleted with the final report. That's seven months before the guarantee is put in place. The question I want to ask is who would have reviewed the report? Would the Minister of the time have been involved in reviewing the report? Who would have interacted with the OECD? And did we find the situation where the key elements which the OECD had identified, which came to pass - liquidity of the banks and the insolvency

of the banks - are completely deleted from the draft final report?

**Chairman:** I said already, Deputy, I do need the question to be made so we can move on.

**Deputy Kieran O'Donnell:** I want to ask can you give me the procedure, how would that have happened?

**Mr. John McCarthy:** The Minister would not see this report until it is published so would have no interaction at all. The process is officials deal with the technocrats in the OECD and then the report is published, usually with the Minister in ... in presence, but he would be informed *ex ante* regarding what's in the report.

I could only find the first reference you're referring to here, that's on the procedure for closing failing banks. I don't see any suggestion from the Department that that should be amended, other than there seems to be something enacted, or something like that-----

**Deputy Kieran O'Donnell:** Yes.

**Mr. John McCarthy:** -----so I don't know why it-----

**Deputy Kieran O'Donnell:** It says "Delete". It says "Delete" underneath it.

**Mr. John McCarthy:** Is that not referring to-----

**Deputy Kieran O'Donnell:** Page 9.

**Mr. John McCarthy:** Is that not referring to, "Transparency in financial markets needs to be improved to restore confidence?"

**Deputy Kieran O'Donnell:** Well, it says, that whole area, "Delete", "Delete" and there's a sign ... a line down by the side. The question I suppose I want to ask is, would it be the general secretary of the Department, would the chief economist of the Department have interacted with the OECD?

**Chairman:** Okay, that's the final question, Deputy. I'm moving on. Mr. McCarthy?

**Mr. John McCarthy:** There was no chief economist in the Department at the time, this is 2008. I currently deal with the OECD and there is an EDRC currently under way, but we will always make comments on OECD reports.

**Deputy Kieran O'Donnell:** I want to know who?

**Mr. John McCarthy:** Who?

**Deputy Kieran O'Donnell:** Who in the Department would have been interacting?

**Mr. John McCarthy:** That would have been the assistant secretary at the time.

**Chairman:** Okay, thank you very much.

**Deputy Kieran O'Donnell:** Who was?

**Mr. John McCarthy:** The assistant secretary in charge-----

**Chairman:** For what period?

**Mr. John McCarthy:** ----- of budget and economic division.

**Chairman:** What period?

**Deputy Kieran O'Donnell:** Period? That was 2008.

**Chairman:** Okay, thank you. So we have that answer. I just want to return to one item there that Deputy O'Donnell dealt with and I'm just going back to ... it's ... the core document's coming up in front of you there, Mr. McCarthy. It's the third paragraph down on it.

**Mr. John McCarthy:** Sorry, Chair, which core document?

**Chairman:** It's coming up in front of you there actually-----

**Mr. John McCarthy:** Oh, yes, okay.

**Chairman:** -----the page itself, so it's DOF01B06, but it's a meeting with David Doyle, former Secretary General, and there's an outline of issues here. It's the third bullet down, which says:

The pace of economic activity was strong [from] 2001-2006 but the Department did not believe that this could continue. In 2005/6 the Minister was advised that the country was depending on unsustainable tax revenues that the economy had been dramatically over-heated and that problems would emerge which would be due to domestic policies and that a more sustainable fiscal position had to be maintained. A presentation to this effect was made to [the] Secretaries General.

Now, in that regard, that's ... the big hidden message there, the country is very, very exposed in a lot of different ways and there is significant trouble pending ahead. Can I ask you how robustly was the Minister challenged on the tax and spending policies implemented in that period by you, your officials and your Department, given that this was the summary and aggregates position of the Irish economy at that time?

**Mr. John McCarthy:** How was ... well, I think what the Minister did on foot of this, which is what I think the Chair is referring to, is that, in 2005, it was announced that there would be a review of the various tax incentives for the property market and, if I recall correctly, most ... I think it was undertaken by Indecon and possibly Goodbody's. And all of the recommendations, from what I recall, or certainly the bulk of them, were contained in the Finance Bill for 2006. In other words, the phasing out of all the ... the biases within the tax system that favoured construction and so forth. However, quite clearly, the horse had bolted at that stage. It was too late. But we had been saying it for some time, the review was done, it was concluded that these tax expenditures needed to be reduced, that the tax treatment of construction needed to be made more neutral and the Minister acted on that. But there was a transition phase, from what I understand, in that you didn't want to ... you wanted to avoid a sudden stop.

**Chairman:** Okay. Given that a lot of these tax incentives were due to be wound up in 2004, could the proposition be made that a review of these tax incentivisations was just a means to elongate their implementation and to put off the day of their removal?

**Mr. John McCarthy:** I genuinely couldn't comment, Deputy. It was handled by the taxation division within our Department and we were not consulted on the economic side.

**Chairman:** Okay, thank you. Deputy Eoghan Murphy.

**Deputy Eoghan Murphy:** Thank you, Chairman, and thank you, Mr. McCarthy, you're very welcome. I'd like to look at Vol. 1, page 88, please in the evidence books and my question relates to the over-exposure of banks to commercial property, which was a flaw identified by the Regling-Watson report and if you look in that evidence book, it's page-----

**Mr. John McCarthy:** Vol. 1, page 81?

**Deputy Eoghan Murphy:** Yes, page 88.

**Mr. John McCarthy:** Okay.

**Deputy Eoghan Murphy:** Yes. So, it's ... this is an issues paper from May 2005 and, if you go down to the fifth paragraph, beginning:

The section has identified the need to explore data sources and development of analysis of non-residential construction as a priority. Data is more limited in this area and up to now. Non-residential construction accounts for about half of construction output so it is worth devoting time to.

So, can you recall, Mr. McCarthy, what steps were taken on foot of that paragraph in the issues note identifying construction related lending and property activity and the need to find more information or develop more data and look into it further?

**Mr. John McCarthy:** I can't recall exactly, but what I suspect, Deputy, was that the assistant principal in charge of the area would have been tasked with looking at various reports that come from the likes of, you know, the kind of construction groups, Savills and so forth, who look at commercial property, what the vacancy rate is in the various urban areas and so forth. So kind of building a database along those lines is what I strongly suspect was the, was the action point so to speak.

**Deputy Eoghan Murphy:** Okay. Well then if we ... if we fast-forward then to March 2006 issues note from the Department, it's on page 92 of the same booklet and it's the third paragraph down, and this is a year later:

The development and analysis of non-residential construction remains important. Data is more limited in this area [and the exact same sentence, non-residential] construction accounts for about half of construction output, so it is worth devoting time to.

Now, this is a year from the issues note of 2005 and it's saying essentially the exact same thing.

**Mr. John McCarthy:** Yes, it is, it is a problematic area, in the sense that data are not readily available in this area, so constructing a database is not a straightforward task. It's not a case of simply looking at CSO data or Department of Environment data in terms of tax ... or house completions and so forth. It's just ... it's not a data-rich space.

**Deputy Eoghan Murphy:** Okay, but in 2005, the assistant principal says, "We need to look at this because we don't have the data." And, a year later, the exact same assistant principal is saying the same thing, so-----

**Mr. John McCarthy:** So, I suspect it's the ... it's the same-----

**Deputy Eoghan Murphy:** Well-----

**Mr. John McCarthy:** Yes, it looks as if-----

**Deputy Eoghan Murphy:** -----it is according to-----

**Mr. John McCarthy:** Yes, yes, okay.

**Deputy Eoghan Murphy:** -----the name given-----

**Mr. John McCarthy:** Yes.

**Deputy Eoghan Murphy:** -----at the top of the section in each issues paper. So can you help me understand? Is the assistant principal being ignored? Is the assistant principal not getting the resources to do this work?

**Mr. John McCarthy:** No, I genuinely ... and I'm only speculating here, I genuinely think it's a function of the lack of reasonable data in this area.

**Deputy Eoghan Murphy:** Even after a year?

**Mr. John McCarthy:** Even after a year, yes.

**Deputy Eoghan Murphy:** A year has passed and still don't have the data?

**Mr. John McCarthy:** Yes.

**Deputy Eoghan Murphy:** Even though it's identified as a significant concern?

**Mr. John McCarthy:** Yes.

**Deputy Eoghan Murphy:** A year later, the Department still can't get the data together?

**Mr. John McCarthy:** That's my suspicion.

**Deputy Eoghan Murphy:** Is that acceptable?

**Mr. John McCarthy:** I'm sure actually if you went out, even now, to try and get a data series in this area, it would be problematic because for house building, you simply go to a time series produced by the Department of the Environment. If you want to look at overall building and construction, you go to the CSO's databank. There is no one, single data point or data series that you can just go to. Instead you kind of have to amalgamate it yourself from a different ... from different sources and then you have to kind of quality adjust the figures as well, you know, what's the vacancy rate? You might get vacancy rates for the urban areas in terms of, you know, industrial units; what's the equivalent in rural areas?

**Deputy Eoghan Murphy:** I think I understand the scale of the problem, or the task, but you're saying it can't be completed within a year?

**Mr. John McCarthy:** I suspect you could probably make a stab at it, but I don't think you could probably complete the information within a year.

**Deputy Eoghan Murphy:** Okay. I want to move on from that then, if I may. I'll just go back a page, to page 91 in the evidence booklet, it's the Government saving scheme, the SSIA, and this note I think you're involved in compiling because your name is there, John McCarthy. The second paragraph, "Impact of SSIA maturity remains an imponderable; we have assumed a low propensity to spend the proceeds." So can I ... do you remember drafting this? Were you

involved in drafting this section?

**Mr. John McCarthy:** I remember looking at the SSIA issue and what the impact ... the issue was, the SSIA's were coming to maturity and we were trying to forecast consumption. So you had this kind of windfall gain that was coming to the household sector, what was going to be the impact on consumption? So what we did, we actually asked the CSO to compile a study on our behalf and to make it public to everybody, so it's in one of their modules as part of the QNHS, to improve the evidence base for us. They did it, they made it public. And on foot of that, we made an assumption then what the marginal propensity to consume from these additional income would be.

**Deputy Eoghan Murphy:** I mean, you say impact remains imponderable, but then you conclude, or you assume, a low propensity to spend the proceeds. So how do you come to that assumption and was the assumption correct?

**Mr. John McCarthy:** This is 2006, I suspect the ... that there may be two issues there, we may have had the CSO study at the time but I genuinely can't remember. The assumption of a low propensity to spend would typically be ... we would tend to have a cautious view anyway, and if it's stronger so be it. But typically you have to remember about 0.6 or 0.7, well maybe closer to 0.6, of everything you and I consume is imported, so it doesn't really impact on GDP that much. It does impact on taxes and on-----

**Deputy Eoghan Murphy:** Is the assumption correct though?

**Chairman:** Supplementary now, Deputy.

**Deputy Eoghan Murphy:** Sorry, was the assumption correct and did the maturing of the scheme contribute to overheating the economy?

**Mr. John McCarthy:** Is it possible for me to come back? I just don't know what the consumption figure was in 2007. I just don't have the figures with me-----

**Chairman:** Okay.

**Mr. John McCarthy:** -----what personal consumption was. I can e-mail the secretariat or whatever what consumption ... but even saying that, you couldn't break down if it was 5%, how much of it was due to the SSIA's maturing and everybody spending the whole lot or people not spending. You simply don't have the information to make that conclusion.

**Deputy Eoghan Murphy:** So you could make a conclusion on ... as to whether or not it might have contributed to the overheating of the economy then?

**Mr. John McCarthy:** You couldn't. You can make an educated guess, but you can certainly not be definitive.

**Chairman:** Okay, thank you. Senator Susan O'Keeffe.

**Senator Susan O'Keeffe:** Thank you, Chair. Mr. McCarthy, specifically, did the Department make attempts to quantify the effects of a soft landing? That is in terms of loss of revenue or increased expenditure, was that a specific task that was carried out? I know you've referred to soft landing before that people have asked you.

**Mr. John McCarthy:** Yes, if you look at the paper that a number of your colleagues have

referred to, we looked at a situation which each 10,000 fall in the level of housing, and the impact on that on GDP, the impact on employment and the impact on the public finances. So on the public finances, it is roughly a half percentage point onto the deficit for each 10,000. So in other words, if housing out by the time went from 80,000 units down to 70,000, the deficit would have been half a percentage point higher because of lower tax revenue and because of higher unemployment payments ... social welfare payments, because unemployment would have gone up.

**Senator Susan O’Keeffe:** Was there any argument about those calculations or were they largely-----

**Mr. John McCarthy:** No, no because ... Senator, the ESRI who use the so-called Hermes model, it’s a very large-scale structural model of the Irish economy, had published a piece of analytical work either just before ours or just afterwards ... we were doing it independently we didn’t even know that they were doing it. And what they did was, they went from, I think, it was 90 down to 50, and concluded that the impact on GDP would be 3%, similar on employment and other variables. Ours was, each 10,000 shaves between a half and one percentage point off the growth rate - so let’s call it the mid-point of that, 0.75%. So you multiply that by four because it went from 90 down to 50 and you’re getting very similar results to what the Hermes model was punching out. So there was a kind of ... we were coming at it from two different ways, so to speak, but we were coming up with the same results. So I think they are plausible results.

**Senator Susan O’Keeffe:** And that was passed obviously on to Government, to anyone who needed it?

**Mr. John McCarthy:** There ... the document, Senator, is in one of the core documents and you can see that it is sent from the Secretary General, it was written by myself, and the current Secretary General, it was sent from the Secretary General of the day to the Minister.

**Senator Susan O’Keeffe:** Not surprisingly, I’d like if I might, to come back to this document again in Vol. 3, the one that has the changes. Because you’ve given in evidence here this morning and you’ve said to us that it was good to provoke thought, I think was the way that you put it, and you talked about changes being purely of a factual nature. I would draw attention then to page 12 of that document, that’s Vol. 3, page 12. It says:

Prior to the weakening in the property market and the recent financial market turmoil, the Irish banks were highly profitable and well capitalised, which will help to adsorb the shock. *But it would also seem important to be prepared for the worst.*

Now when that came out in the report, the final report, it said, “The Irish banks are highly profitable and well capitalised, so they should have considerable shock absorption capacity, but it would also seem important to be prepared to deal with downside risks.” Now it seems to me there’s quite a difference between saying the Irish banks are highly profitable and, prior to the weakening, the Irish banks were highly profitable. And they should be “prepared of the worst” turns into “downside risks”. Would you continue to describe that as a factual change?

**Mr. John McCarthy:** I think in my evidence earlier on I said yes, there would be some factual changes but we would also give some nuances. That ... I think that probably falls into the definition of a nuance, but I would stress those sort of changes would not have come from the budget and economic division. It could even be, Senator, that the OECD themselves ... I

actually couldn't follow where the text was. Sometimes the secretariat in the OECD can nuance these things themselves. So it's not necessarily coming from the authorities. They have an internal process themselves, but to come back to your question-----

**Senator Susan O'Keefe:** That was marked "delete", that was marked "delete".

**Mr. John McCarthy:** Oh was it? Okay.

**Senator Susan O'Keefe:** Oh it was, yes.

**Mr. John McCarthy:** I think that falls more into the nuanced rather than the factual.

**Senator Susan O'Keefe:** And again on page 20 of the same document, there's one sentence, "Implement an insolvency procedure, specifically adapted to banks." That was a summary of recommendations on financial stability. There's a line put through that and indeed it does not appear on page 38 where the summary of recommendations on financial stability appear.

Now, I want to draw your attention if I may to page 6 of your own statement that you provided to us. You say:

On the international front, the European Commission, the OECD and the IMF provide expert advice. Over the period 2000-2007, the advice of these institutions was, by-and-large, similar to the advice being provided by the Department of Finance.

We might conclude, Mr. McCarthy, that the advice was similar, because the Department of Finance had a say in this document and had the capacity to change it, so I would argue that its not surprising that the advice was similar. And we've heard others give evidence here of changes made to similar international documents and I wonder, you know, whether, if you like, the public is aware that the documents that are held up as being-----

**Chairman:** We're running out of time now Senator I need you to put the question.

**Senator Susan O'Keefe:** Yes. Documents held up as being the ones that were international advice, had in fact quite a significant input made by our own Department of Finance and other institutions in Ireland.

**Mr. John McCarthy:** Again, I would stress we're not unique in this at all-----

**Senator Susan O'Keefe:** That doesn't make it right though.

**Mr. John McCarthy:** Well, certainly when there are factual issues, we would have a better understanding of how the Irish economy operates than the OECD and the IMF-----

**Senator Susan O'Keefe:** But the ones I've drawn your attention to are not-----

**Mr. John McCarthy:** Yes-----

**Senator Susan O'Keefe:** -----factual.

**Mr. John McCarthy:** -----they're more nuanced, I accept that. What I can say on ... I mean I've never had any interaction on any banking type issues. I think the Chairman, when he read the opening statement, I've never been involved on that side so I can't make any comments on why there would have been changes on bank capital and issues like that.

**Senator Susan O'Keefe:** But "nuance" is a polite word-----

**Chairman:** Final question, Senator.

**Senator Susan O’Keeffe:** -----for a change. Isn’t it? A nuance is a polite word for changing something that ... those arguably were quite significant points that were made in that document.

**Mr. John McCarthy:** Some of them are, yes.

**Senator Susan O’Keeffe:** Yes, so they’re not-----

**Mr. John McCarthy:** Yes.

**Senator Susan O’Keeffe:** So calling them nuanced seems to me to soften them a bit. I’m arguing that it’s no wonder that the advice was similar.

**Chairman:** You are arguing, you need to ask a question.

**Senator Susan O’Keeffe:** I’m asking. The advice your ... you have said in your statement is similar, I’m saying its similar for a very good reason and that is that the Department of Finance had an input into the advice.

**Mr. John McCarthy:** No, no ... I mean, the ... I mean, the institutions would ... would make recommendations to the Irish authorities. That is ... that is factual. That will always happen. There will always be a situation which we might want to nuance but it is up to the authorities, to the foreign authorities, whether or not they want to take on board these comments. I said at the ... earlier on that, on occasion, I would actually have preferred if the international organisations were even more hard-hitting. So I don’t take the view that we need to nuance it and make everything pretty for Government and so ... sometimes we need them saying even more difficult things because there’s messages we can’t say that they need to say.

**Chairman:** Okay, thank you. I’m going to move towards wrapping up. And just to deal with two matters before I invite Senator Barrett and Deputy Phelan to close themselves, if I maybe could ask you that in the past then - this is coming from our earlier discussions of this morning, Mr. McCarthy - a major problem was that there was no banking or financial experts working in the economic division. Has this issue now been addressed or responded to in the meantime?

**Mr. John McCarthy:** What we have, Chairman, is we have economists ... ramped up the number of economists in the economic division and we have ramped up the number of banking specialists in the banking division. They’re on secondment, typically, from the NTMA. But we do interact much more. So I mentioned the policy committee. So there is more joined-up thinking. The rationale behind this policy committee is to break down the silo approach to make sure that everybody is on the same page. So not ... to specifically answer your question, not financial experts in the economic division - they’re in a separate division - but we work closely.

**Chairman:** Okay. And just on the broader issue of groupthink, which was mentioned earlier and you mentioned it yourself and the mentality that goes with it - specifically in your response to Deputy Phelan’s question, how is it now ensured today that no groupthinking culture can take hold again in the economics division? If you move people out of silos and move them into a broader sphere, you can still have a groupthink on a broader sphere, even not in a silo, so how is that being addressed?

**Mr. John McCarthy:** Well, I mean, what we’re doing, and what the economic division

is doing, and what we've been very proactive is ... is engaging much more with the outside economics community. I have encouraged my team to publish a lot more of the technical work. So we have technical papers, we have working papers - they're all online. You can see some of the views that we have. Let me give you a specific example: we recently, somewhat controversially, made a submission to the Low Pay Commission, which was actually contrary to Government policy. The Minister was in favour of us doing it, not because he necessarily agreed but he doesn't want the, sort of, groupthink to take hold again. This was reported in parts of the media. So we are making these submissions on issues that we think are important and they're not necessarily in line with Government policy. So there is a practical example in that particular one, Chairman.

**Chairman:** Okay. And, finally, just in reference to Senator O'Keeffe's earlier question on quantifying the effects from soft landings on Government finances - and just maybe to expand upon that - that apart from the general impact on GDP and the impact on Government surplus/deficit, were there also concrete and specific estimates made on changes in the amounts of stamp duty, capital gains taxes and other property-related taxes?

**Mr. John McCarthy:** No, no, no. It was purely the first round effects that we looked at.

**Chairman:** Okay.

**Mr. John McCarthy:** What's the impact on stamp duty? What's the impact on CGT? But it didn't mean, from a policy perspective, that we were recommending any changes to those variables.

**Chairman:** If those measures were included in the modelling, would it have given you a different type of approach or a different type of finding?

**Mr. John McCarthy:** Yes, I think the finding probably would have been different. It depends on, of course, what the policy recommendation might have been.

**Chairman:** More accurate?

**Mr. John McCarthy:** Well, I think the figures are reasonably accurate themselves because they do tally with what the ESRI's HERMES model had punched out through the hundreds and hundreds equations that are included in that. So I'm quite happy to stand over - and I do stand over - the results that are in that model.

**Chairman:** Okay. Thank you. Senator Barrett, three minutes.

**Senator Sean D. Barrett:** Thank you, Chairman. Do we know the nationalities of that OECD team that came to Ireland in 2008?

**Mr. John McCarthy:** Yes.

**Senator Sean D. Barrett:** Yes. Could you tell us, yes?

**Mr. John McCarthy:** I'm trying to think who was on ... I think one person whose name is listed there is Sebastian Barnes, who's from the UK. He's currently a member of the Fiscal Advisory Council.

**Senator Sean D. Barrett:** While you're looking, I mean, they would quite likely come from countries which had a much smaller banking crisis than Ireland, so, I think, listening to

them ... could I point out when you compare, in Vol. 3, the summary recommendations on financial stability on page 20 that the OECD recommended ... there were five and only three of them made it through to the final version which is on page 38, the last page of Vol. 3. I also note that paragraph 90 on page 17 was deleted and what it ... it ... it says how to deal with bank failures and how the regulator could have closure authority and you could ensure there wouldn't be a run on the banks and - a deposit interest run - and that the losses should be confined to shareholders. Was that not vital information for us to have as we faced into the banking crisis in 2008?

**Chairman:** I need the questions and answers wrapped up in the three minutes now. So, Mr. McCarthy?

**Mr. John McCarthy:** Having had no role in deleting it, I would absolutely agree with the Senator, yes.

**Senator Sean D. Barrett:** Okay. Now, page 61 in Vol. 2, the final question - and thanks, Chairman - your notes for the Minister, "the bank expresses concern about ... high current rate of credit growth, including mortgage credit, which has been increasing ... around 25 per cent.", and the Minister advised, "I would encourage the Central Bank and Financial Regulator to remain vigilant on the issue of personal credit and mortgage debt." Surely he was gone beyond remaining vigilant and there was need for action to deal with that 25% annual increase.

**Mr. John McCarthy:** I would agree and if it had have been up to me, macro-prudential tools would have been implemented at the time.

**Chairman:** Okay, thank you very much.

**Senator Sean D. Barrett:** 124 was "[We] note[d] [on 10 July 2008] Irish banks were well capitalised with good asset quality and the banking sector's shock absorption capacity remains strong." That was only ... that was in July and, you know, they were in trouble by late August and September.

**Mr. John McCarthy:** Yes, in terms of compiling these notes, we get input from around the house and that was the line at the time, not my line but-----

**Chairman:** Thank you. Deputy Phelan.

**Deputy John Paul Phelan:** Thank you, Chairman. Mr. McCarthy, earlier, when I was asking you about analysis of other crashes, you referenced Japan. Can I ... as the chief ... or one of the countries that have been examined, why were we analysing a country with an independent monetary policy, given that our own monetary policy is exogenous and, you know, it's a complete difference from Japan, I suppose? And, furthermore, you referenced, when you were talking about why the soft landing theory gained such traction, that in Ireland we hadn't had reductions in property values before. Is it not a central tenet of macroeconomic forecasting that you don't derive future outcomes from localised past history?

**Mr. John McCarthy:** Just on the first question, why Japan has an independent monetary policy, just the Kelly paper, which is, sort of ... also looked at the experience of 30 countries - I think it's 30 - across the OECD, and they, of course, had independent monetary policies as well. So I think that point needs to be borne in mind. On the second point, I mean, typically, economists, when they're looking at issues, they look at what's happened at the past. Does it set a precedent? Or they look at kind of cross-country experiences.

**Deputy John Paul Phelan:** But they're not bound, in a sense.

**Mr. John McCarthy:** No, no, absolutely not.

**Deputy John Paul Phelan:** You gave that as the major, kind of, reason for that thing.

**Mr. John McCarthy:** It was one of the reasons for ... I mean, you had not seen nominal price declines. The big problem at the time, Deputy, was that, you know, you had seen massive structural change in the Irish economy from the mid-1990s up to 2007. Now, some of that was real - it was the Celtic Tiger, it was the convergence of *per capita* incomes, it was real growth, it was driven by the traded sector of the economy - and the price increases were all justified on that basis. The problem was from 2002, 2003 you saw a misallocation of resources away from the trading sector and into the non-trading sector.

**Deputy John Paul Phelan:** And that's fair enough but the point I'm getting at, we shouldn't ... or should we have been basing our soft landing analysis on the past history of the Irish housing market as that kind of central plank, that we should have been looking outside,? Isn't that the way economics works?

**Mr. John McCarthy:** Well, I think on the soft landing, the key point that I would make is that, rather than the volume side, we've devoted a lot of time to that, but on the prices side, even if there is over-valuation, it does not necessarily mean that there can be ... that there will necessarily be massive destruction to the real economy. So it was a point I was making earlier on that you can see modest declines in prices-----

**Deputy John Paul Phelan:** My time has ended and I don't wish to cut you short but we should ... just simply putting the question to the ... and I'm not blaming you specifically, you were part of a wider team at the time, but we should not have been basing that analysis on the main plank of it being that Irish house prices hadn't fallen in the past.

**Chairman:** Are you making a statement now, Deputy, or are you asking a question?

**Deputy John Paul Phelan:** No, I'm just asking that question in light of ... I've studied economics for years and past history in any localised situation, we're always warned against using that as the basis of future analysis and development.

**Chairman:** That's your question. Mr. McCarthy, can you respond to that please and we'll move to wrap things up then?

**Deputy John Paul Phelan:** What I am saying-----

**Chairman:** Sorry, Deputy, I must stop you there now. No more questioning.

**Mr. John McCarthy:** It can be used as a guide but it's not the be all and end all. I would accept your point that there are limitations of looking at the historical experience. As I mentioned to Deputy Higgins, you know, we had the historical experience of the Great Moderation. That looked as if everything was great for the next 20 years and so forth, suddenly things changed overnight. So, it can be used as a tool but, you know, there are, there are limitations and there are health warnings with the tool.

**Chairman:** Thank you very much. Okay, Mr. McCarthy, I am going to bring things to a conclusion. Is there anything else you would like to further add to this morning's proceedings before I close?

**Mr. John McCarthy:** No, thank you, Chairman.

**Chairman:** Okay, with that said I'd like to thank Mr. McCarthy for his participation today and for his engagement with the inquiry. The witness is now formally excused and I propose that we suspend until 11.30 a.m., at which time we will recommence our engagement with Mr. Cardiff. Is that agreed? Agreed.

*Sitting suspended at 11.12 a.m. The joint committee resumed in private session at 11.36 a.m. and went into public session at 11.39 a.m.*

### **Department of Finance - Mr. Kevin Cardiff**

**Chairman:** Okay, so we will now commence with session 2, public hearing discussion with Mr. Kevin Cardiff, former Secretary General, Department of Finance. The Committee of Inquiry into the Banking Crisis is now resuming in public session, and can I ask members and those in the public Gallery to ensure that their mobile devices are switched off.

Today we continue our hearings with the senior officials from the Department of Finance who had key roles during the crisis period. At our next session this morning we will hear again from Mr. Kevin Cardiff, former Secretary General of the Department of Finance. This second session will focus upon developments during Mr. Cardiff's tenure from January 2009 until he left the Department. Mr. Kevin Cardiff was Secretary General at the Department of Finance from 2010 to 2012. He joined the Department in 1984 and had a number of roles in the Department including responsibility for the taxation and financial services division and tax policy. In March 2012 he was nominated as Ireland's representative to the European Court of Auditors in Luxembourg for a six-year period. Mr. Cardiff, you are welcome back before the inquiry today.

Before hearing from the witness, I wish to advise the witness that by virtue of section 17(2) (I) of the Defamation Act 2009, witnesses are protected by absolute privilege in respect of their evidence to this committee. If you are directed by the Chairman to cease giving evidence in relation to a particular matter and you continue to do so, you are entitled thereafter only to qualified privilege in respect of your evidence. You are directed that only evidence connected with the subject matter of these proceedings is to be given. I would remind members and those present that there are currently criminal proceedings ongoing and further criminal proceedings are scheduled during the lifetime of the inquiry which overlap with the subject matter of the inquiry. The utmost caution should be taken not to prejudice those proceedings. Members of the public are reminded that photography is prohibited in the committee room. To assist the smooth running of the inquiry, we will display certain documents on the screens here in the committee room. For those sitting in the Gallery, these documents will be displayed on the screens to your left and right. Members of the public and journalists are reminded that these documents are confidential and they should not publish any of the documents so displayed.

The witness has been directed to attend the meeting of the Joint Committee of Inquiry into the Banking Crisis. You have been furnished with booklets of core documents. These are before the committee and will be relied upon in questioning and form part of the evidence of the inquiry. So if I can now ask the Clerk to administer the affirmation to Mr. Cardiff.

*The following witness was sworn in by the Clerk to the Committee:*

Mr. Kevin Cardiff, former Secretary General, Department of Finance.