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Joint Committee of Inquiry into the Banking Crisis

Witness Statement of

Donal McNally

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[1] *See s.37 of the Houses of the Oireachtas (Inquiries, Privileges and Procedures) Act 2013*

0ireachtas Banking Inquiry

Witness Statement of Donal McNally

Former Second Secretary General

Department of Finance and PER

In accordance with the directions of the Joint Committee, I submit the following witness statement to the Banking Inquiry.

By way of personal background, I have worked in the Department of Finance in several areas since I joined it – Banking Section, Health Expenditure, Tax policy until 2000, Budget and Economic Division to 2008 and Public Expenditure Division till my retirement in 2012. I was promoted to Assistant Secretary in 1994 and to Second Secretary General in 2000.

I have a primary degree in Economics from Trinity College Dublin (1975) and a Master's degree also from TCD in 1998. In my capacity as Second Secretary General from 2000 to 2008 I was a member of the Economic and Finance Committee of the EU and attended Economic and Finance Councils and some Euro group meetings with the Minister for Finance.

In my time in Public Expenditure Division I served on the Review Group on Public Spending, commonly referred to as Bord Snip and on a similar body in relation to local authority spending.

The Committee has directed me to respond in relation to specific areas of policy making which I will do below. Some of these areas I am more familiar with than others. In particular, I can comment on economic and fiscal policy advice but have much more limited expertise in banking or prudential policy. I will endeavour to help the Joint Committee as far as I can.

Appropriateness and Implementation of Macroeconomic Policy – Ref R1(c) and R2(b)

The principal area on which I can comment is the nature and appropriateness of macroeconomic policy. I have no relevant insights into the prudential policy area during the period under review so I will confine myself to the former for the purposes of this statement.

The macroeconomic policy advice does not include monetary policy, interest rates or exchange rates as these were the sole preserve of the ECB under the Treaty. The advice therefore related to fiscal policy and structural aspects of the economy at macro level.

The basic fiscal policy advice provided during the period was to achieve a General Government Balance in surplus or close to balance and to avoid economic decisions that added unwisely to aggregate demand in the economy. Economic policy advice supported the maintenance of competitiveness, moderation in wage and income increases, matched as far as possible by increases in productivity, more competition in the sheltered sector of the economy and pro employment tax and social welfare policies.

There was also a concern to increase the supply capacity of the economy by maintaining capital investment at a high rate and removing infrastructural bottlenecks.

This policy advice was appropriate in my view as it was in line with the requirements of the EU Stability and Growth Pact (SGP) for members of the Eurozone and in general with the Broad Economic Policy Guidelines of the EU adopted annually by the Economic and Finance Council.

The only notable exception to this is the recommendation issued to the State in 2001 by the Economic and Finance Council under Article 99(4) of the Treaty to take countervailing budgetary measures during 2001 to avoid overheating. This recommendation was not felt warranted and was not accepted by the Irish authorities.

Advice from D/ Finance to Government – Ref R5(b)

The Department's advice referred to above was encapsulated in the annual Budget Policy Memorandum submitted to Government each summer setting out the proposed economic and fiscal parameters for the annual Budget then published in November / December. They were also reflected in advice on individual policy decisions that might arise during the year.

For the period from 1995 to 2007 the economy doubled in size with growth rates of around 7% per annum on average. A budget surplus was achieved in most years. Unemployment fell from 12 % to 4.5 %. The labour force doubled from just over 1m to just over 2m. Consumer prices also rose at a fast pace rate in the first part of the period moderating from 2002.

Asset prices also increased substantially as is well recorded in the property area. This reflected monetary policy decisions at the EU level as well as the strength of domestic demand and certain tax incentives. The composition of output also shifted more to the domestic side from 2002, with export growth having taken the lead up to then.

In commenting on the Department's advice in its Report on strengthening the capacity of the Department of Finance (December 2010) the Wright group did find that the Department's advice was generally appropriate (para 3.2.7) and did provide clear warnings on the risk of pro-cyclical fiscal actions but that this advice should have been adapted in tone and urgency as the period progressed. This advice was not always heeded in the rate of spending increase or tax cuts.

Key Drivers of Budget Policy – Ref R5(c)

As the Wright Report also noted, apart from strong revenue growth as a budget policy driver, there was also the role of Programme for Government commitments and the desire to achieve the goals set out in Social Partnership. These were considerable counterweights to a policy of more limited fiscal growth.

The strength of demand which fuelled the domestic economy at the time was the result of both accommodating monetary and fiscal policy. To offset the pro-cyclical effect of low interest rates and easy money would have required running a significant General Government Surplus with more limited tax reductions and public spending restraint at a time of bumper revenues.

There appeared to be little public support for such restraint given the near universal praise at international level for the performance of the Irish economy and the general economic consensus of both domestic and international commentators (EU, OECD, and IMF) that significant positive growth was to continue with moderate inflationary pressures as measured by the CPI.

Contrarian views Ref R4(c)

Cautionary and contrarian views are always hard to get across in an environment of strong economic growth. It is important to listen carefully to contrarian views to assist in policy making. In my experience only limited contrarian views were expressed and the majority held to the soft landing consensus as I did. There would be obvious difficulties in delivering a policy line that did not conform to the strong consensus.

The challenge for the future will be the need for the system to communicate the message more successfully at policy level to the public that there is a case for restraint even when resources allow and the wisdom of using surplus funds to reduce debt now to lessen the substantial interest burden into the future.

It is also clear that the EU believes that closer monitoring of member states budgets, more constraints on member states freedom of action and firmer rules on budgetary policies will bring about greater fiscal responsibility.

Relationship between CB, D/F and banking institutions – Ref R3(b)

Turning to the specific areas of banking policy, I have no recent experience of banking supervision and prudential policy or of relations between the Central Bank and individual institutions.

Effectiveness of Communications between CB and D/Finance – Ref R3(c)

Communications between the Central Bank and the Department were positive and constructive in my experience. The Bank interacted mainly with Finance Division of the Department and the Secretary General was a member of the board of the Bank. The Bank was also represented at the EU Economic and Finance Committee and the Governor attended the informal

Eco-fins. The Bank also dealt at economist level within my Division on economic forecasting and commentary.

Skills and Resources – Ref R1(d)

The Bank was also helpful in seconding economists to the Division when it was desired to strengthen the available resources of economists by this route and by recruiting economists by special public competition. The Wright Report noted the weakness of the Department in this regard in its findings.

There were difficulties at times in securing persons of appropriate skills and experience from within the Department for the economic function. Some staff saw being labled in a technical area as unhelpful to future promotion. The situation on economic resources has improved a good deal compared to the earlier years of the last decade.

Advice to Government – Ref R5(b)

I was not involved in the discussions or policy considerations leading up to the giving of the Government guarantee or in relations with the banks and other credit institutions following the guarantee. I cannot be of assistance to the Committee therefore in that regard.

<u>Assessment and communication of solvency and liquidity risks – Ref R2(c)</u>

I have no information on the adequacy of the assessment and communication of both solvency and liquidity risks in the banking institutions and sector other than that gleaned by following some of the recent work of the Committee.

<u>Expert Advice – Ref R4(a)</u>

In relation to the use of outside expert advice in my time this was mainly in the area of tax issues and tax relief schemes where independent advice was seen as necessary. The standard of this advice was good and generally followed.

<u>Relationship between Government, Oireachtas, banking sector and property sector – Ref R5(d)</u>

In regard to the appropriateness of the relationship between the Government, the Oireachtas, the banking sector and the property sector, my contacts with the sector were mainly in the context of pre-Budget submissions and meetings and Social partnership discussions. Contacts with developers on individual issues e.g. the operation of tax reliefs were usually at the level of the section in the Division dealing with such reliefs.

Finally, it is a matter of regret for me that the country suffered from a period of recession and austerity in restoring the public finances. We should not lose sight of the fact that the economy grew soundly for many years up to 2008 as did employment and wage levels. Hopefully the experience will serve to instruct policy makers and advisors for the future in responding to such situations in a timely manner.