JOINT COMMITTEE OF INQUIRY INTO THE BANKING CRISIS

Witness Statement

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1. Introduction

I refer to the Direction to attend before the Committee and make a statement in writing pursuant to section 67(1)(d) of the Houses of Oireachtas (Inquiries, Privileges and Procedures) Act 2013, dated 14th May 2015 (hereafter the 'Direction').

I note that the Direction relates to my role as "Chief Economist and Assistant Secretary and all other relevant roles in the Department of Finance".

2. Career information

As outlined in my letter to the Chair of the Joint Committee, dated 6th May 2015, I was appointed to the position of Chief Economist – which is at the Assistant Secretary level in the civil service – in mid-November 2013, following an open competition run through the normal TLAC process.[1]

Prior to being appointed Chief Economist I worked in the Economic Division of the Department on a secondment arrangement from the Central Bank (between 2001-2003 and 2004-2010 at a level equivalent to that of Assistant Principal in the civil service and, between 2010-2013, at a level equivalent to that of Principal Officer in the civil service). Organisation charts illustrating my role within the Division have previously been supplied to the Joint Committee.

3. Lines of Inquiry – general comments

At all times during my period in the Department my work has focussed, in the main, on macroeconomic and budgetary analysis.

On no occasion was I employed in the banking or financial services divisions of the Department. In this regard, I previously submitted that it is not appropriate that I be directed to attend or to submit a statement in writing in respect of the lines of Inquiry R2c, R3b, C1a because I did not, at any time during the terms of reference of the Joint Committee, have responsibility in these areas. I wish to thank the Committee for removing R2c from the lines of inquiry.

4. Lines of Inquiry – specific comments

R1c: Appropriateness of the macroeconomic and prudential policy

My roles in the Department have related to macroeconomic and budgetary issues, so I will focus on macroeconomic policy in my comments below.

Upon adoption of the single currency in 1999, monetary policy was set by the European Central Bank having regard to economic conditions in the euro area as a whole. This policy instrument, therefore, could not be deployed to meet Irish-specific requirements.

At the outset of monetary union, full employment had effectively been achieved in Ireland, and the economy was operating at – or at least close to – full capacity. The decline in real interest

[1] Top Level Appointments Commission for appointments at Assistant Secretary level and higher in the civil service.

rates (policy rates declined while at the same time the rate of inflation picked-up) fuelled a substantial increase in credit growth, the bulk of which was channelled into the property market.

The resultant large increase in the investment-GDP ratio (mainly related to investment in building and construction) was not matched by a commensurate increase in the national savings rate. Therefore, from 2005 onwards the current account of the Irish balance of payments moved into significant deficit, with foreign savings – routed through the Irish banking system – filling the domestic savings-investment gap. Greater capital mobility, arising from both the advent of monetary union as well as the globalisation of financial markets, facilitated this. Some analysts felt, at the time, that the balance of payments was less relevant within a monetary union, as changes in this variable had no implications for the exchange rate. In reality, more attention should have been paid to this indicator (the balance of payments), given its high information content.[2]

On balance, monetary union has been positive for the Irish economy, and it is important to emphasise that in Ireland we have never had a fully independent monetary policy.[3] However, it is fair to say that the regime change associated with participation in monetary union was not fully taken on board in the policymaking process. In particular, with the economy operating at full capacity, fiscal and incomes policies should have been counter-cyclical in order to stabilise aggregate demand; in reality these policies were pro-cyclical, at least in the aggregate over the period, aggravating the imbalances that had already emerged.

In terms of fiscal policy, it is technically difficult to assess the fiscal stance both in real time and even after the event in a small open economy such as Ireland. However, the fact that general government expenditure rose by over 110 per cent in the period 2000-2007 provides clear evidence of pro-cyclicality. Incomes policy was no different: the public sector wage bill rose by over 120 per cent over the period, with increases in both headcount and earnings per capita.[4]

In summary, therefore, the stance of macroeconomic policy was inappropriate. Without an independent monetary policy, fiscal and incomes policies should have been counter-cyclical in order to stabilise aggregate demand and build up buffers in order to cushion shocks that inevitably emerge. In practice, the pro-cyclical stance of macroeconomic policy (monetary, fiscal and income policies) ultimately resulted in a misallocation of resources to the non-traded sector (especially construction), a substantial loss in competitiveness and a crowding-out of the traded sector, the latter being the normal engine of growth for the Irish economy.

As highlighted in the Wright Report,[5] the Department warned against adopting inappropriate policies, and that it's advice was "*more direct and comprehensive than concerns expressed by others in Ireland, or by international agencies*" (pg. 5). However, the Report also found that the Department should have adapted its tone as vulnerabilities were increasing. I would agree with these findings.

[2] Indeed, under the reformed economic governance framework now in place in the European Union, the current account of the balance of payments is now one of the key indicators in the so-called 'scoreboard' – the set of economic indicators used in the Macroeconomic Imbalances Procedure.

[3] Up to 1979, monetary policy was effectively determined by the one-for-one, no margins link with sterling; thereafter and up until the onset of monetary union, monetary policy was effectively determined by our membership of the Exchange Rate Mechanism of the European Monetary System.

[4] The figures for general government expenditure and the public sector wage bill are sourced from the national income and expenditure data published each year by the CSO.

[5] *Strengthening the capacity of the Department of Finance*, Report of the Independent Review Panel, December 2010.

JMC01D

JMC00005-003

R1d: Composition, skills, experience and number of resources at the Central Bank, Financial Regulator and Department of Finance

I will comment on the resourcing, skills and experience of economists in the Department of Finance drawing, in part, from the analysis contained in the Wright Report.

The Wright Report provides significant detail on the insufficient number of economists in the Department during the bubble period, while stressing that many of those at the time were "*public servants of the highest calibre and excellent practitioners of applied economics*" (pg. 44).

There can be no doubt that the number of economists in the Department was inadequate at the time and this has been, and continues to be, addressed.

However, it is worth pointing out that institutions which employ hundreds (if not thousands) of economists failed to anticipate the global crisis. In this regard, I would recall the findings of the Nyberg Report,[6] namely that "*central banks and regulators abroad generally were almost as unsuspecting of growing financial fragility as their Irish counterparts. The method of regulation or the number of available macroeconomists does not generally seem to have made a great deal of difference*" (pg. 88).

So there is an important point that needs to be made: economics, as a field, failed on a number of counts and this has prompted much soul-searching within the profession. While there were some notable exceptions, the economics profession failed in a number of aspects, including:

- in its ability to foresee the crisis;
- to acknowledge that cataclysmic breakdowns in a market economy were indeed possible;
- in the widespread assumption that the business cycle had been permanently 'tamed';
- to better understand the inter-linkages between the real and financial sectors.

One common strand running through all of these short-comings relates to the role of the financial sector.

For the most part, traditional economic models failed to take sufficient account of possible systemic risks emanating from the financial sector. Models relied on the assumption that financial markets were smooth and efficient, and that the cost of credit was driven by short-term (central bank) policy rates, with arbitrage and risk-adjustment determining longer term rates (the 'cost of capital'). Financial intermediation, under these assumptions, was largely seen as a 'given'. When the crisis took hold, the massive increase in global risk-aversion, the drying up of liquidity and the need for deleveraging (among corporate, household and public sectors) were not sufficiently captured in the models, with the result that the impact of financial sector stress on the real economy was not fully understood.

As a result, economists in virtually all Finance Ministries and Central Banks were, at least to some extent, under-prepared once the crisis hit.

[6] *Misjudging risk: causes of the systemic banking crisis in Ireland*, Report of the Commission of Investigation into the Banking Sector in Ireland.

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R2b: Nature and effectiveness of the operational implementation of the macroeconomic and prudential policy

I will comment on the implementation of fiscal policy.

The implementation of fiscal policy was generally-speaking poor, with the outturn fiscal position often even more pro-cyclical than suggested by the stance taken at the time of the Budget.

This reflects weak implementation, most notably on the expenditure side, where there were frequent overruns. O'Leary (2010),[7] for instance, notes that "*the first feature that all the budgets of the 2001-2007 period have in common is disproportionately rapid current expenditure growth. Another, related, feature that is common to six out of the seven budgets (2006 is the exception) is that an already generous initial spending allocation was exceeded. In some years the margin of overshoot was very large*".

Insufficient consideration was attached to such overruns given that these were typically offset by higher-than-anticipated revenue flows, albeit from a tax base that was being narrowed over time. In other words, part of the unexpected (temporary) revenue buoyancy was used to finance (permanently) higher public expenditure rather than debt reduction, ultimately leading to a deficit that was mostly structural in nature.

R3b: Nature and appropriateness of the relationship between the Central Bank (including the Financial Regulator), Department of Finance and the banking institutions

From the perspective of the economic division of the Department, (professional) contact with the domestic banks was limited to discussing ad-hoc queries on technical aspects of the Department's forecasts (e.g. exchange rates assumptions underlying the export forecast, etc.).

This was completely appropriate – part of the economic division's role was (and is) to communicate and explain the Department's forecasts to the wider economics community.

R3c: Effectiveness of the communication between the Central Bank and the Department of Finance

I will comment here on communication between the economic divisions of both institutions.

There were (and there remains) good lines of communication between the economic division of the Department and that of the Central Bank – I would point out that I previously worked in the economic division of the Central Bank.

It is important to stress that these discussions centred, in the main, round the short-term economic outlook. In this context, it is normal practice for the Bank to circulate a draft copy of its bulletin to the Department (usually to me) typically a few days in advance of publication.

The purpose of this is two-fold. Firstly, it provides for a sense check. Secondly, the advance copy of the bulletin allows the economic division to prepare a short note for the Minister which is circulated shortly before the bulletin is published.

[77] O'Leary J. *External Surveillance of Irish Fiscal Policy During the Boom*, Irish Economy Note No. 11.

It was not the Department's practice to share its forecasts with the Bank in advance of publication – it was essentially a one-way process. However, when the crisis took hold the communication became more of a two-way street. We would prepare our projections in the Department and, given the depleted resources in the economic division at the time and the unprecedented levels of uncertainty, discuss these informally with the Bank (again as part of a sense-checking process).

Finally, from time-to-time certain issues will arise and the economic division will discuss these bilaterally with the relevant sections in the Central Bank (e.g. statistical issues, implementation of quantitative easing).

R4a: Appropriateness of the expert advice sought, quality of analysis of the advice and how effectively this advice was used

Generally-speaking, the economic division of the Department does not 'outsource', instead conducting its analysis in-house. One notable exception relates to macro-econometric modelling, whereby, from time-to-time, we will ask to ESRI to simulate the HERMES model on our behalf in order to assess the economic implications of various 'shocks' (e.g. impact of oil price changes on the economy and public finances).

A number of institutions – domestic and international – provide expert economic policy advice on a periodic basis. On the domestic front, the ESRI (quarterly economic commentary) and Central Bank (quarterly bulletin, annual Governor's letter in advance of the Budget) provide expert advice to Government. On the international front, the European Commission, OECD and 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 to Government. *Inter alia* the various institutions highlighted (to varying degrees):

- the deterioration in competitiveness;
- the over-exposure of the economy to house-building;
- the growth of credit and the rise in household indebtedness;
- the inappropriate stance of fiscal and incomes policies;
- the exposure to external shocks.

In relation to the housing market, the prevailing consensus was for a 'soft landing'. In terms of housing activity, this implied a gradual reversion to lower but more sustainable levels of output. In terms of prices, it implied that, even if house prices were over-valued in real terms, a modest reduction in prices combined with continued income gains would result in a closer alignment of prices with so-called 'fundamentals' (disposable income, interest rates, changing demographics, etc.).

In speaking notes prepared for Ministers, the general approach was to highlight the central scenario of a 'soft landing' but to also outline that there were risks to such a benign outcome.

Generally speaking, the main short-coming of the advice (including that of the Department) was the absence of any significant read across to financial stability – the baseline assumption of most commentators was that shocks to the economy emanating from the housing market could be adequately absorbed by the banking system. Ultimately, however, the exposure of the banking system to development-related loans was not fully appreciated, and there was a generalised failure – including by the Department – to join the dots between the property market bubble and financial stability. Having said that, it was not unreasonable to assume that, in establishing an independent Central Bank / Regulator with responsibility to monitor, assess and advise regarding financial stability, this function would have been implemented in a satisfactory manner.

R4c: Analysis and consideration of the response to contrarian views (internal and external)

The Department did provide a contrarian view, arguing on a number of occasions that fiscal policy was pro-cyclical and that the economy was excessively exposed to the property sector. This is one of the key findings of the Wright Report, which examined the Department's advice to Government in the annual (unpublished) *Budget Strategy Memorandum*.

In terms of the Department's published documentation, the property market and the construction sector more generally were identified as risks to the economy and to the public finances in the annual *Stability Programme Update*, *Economic Review and Outlook* and *Pre-Budget Outlook* from 2004 onwards. Having said that, and as outlined earlier, another key finding of the Wright Report was that the Department could have been more forceful in its advice and I would certainly acknowledge this.

A number of commentators offered contrarian views regarding the domestic property market, and there is a perception that a different, more benign outcome for the economy would have been achieved if greater weight had been placed on such views. The reality, however, is that most contrarian views emerged from late-2006 onwards: with very strong credit growth having already occurred in the 2003-2006 period. Moreover, some of the contrarian views emerged only as house prices had already begun to decline.

Most of the contrarian views focussed on house price overvaluation and (to a lesser extent) on the excessive level of house building. Some correctly highlighted the concentration of bank lending in the property sector. From what I can recall, however, there was little discussion regarding key factors such as:

- the exposure of the banking system to a relatively small number of highly leveraged borrowers;
- the lack of equity throughout the system, with the result that the banking system was bearing most of the risk.

R5b: Appropriateness of the advice from the Department of Finance to Government and the use thereof by Government

As has been documented in the Wright Report, the Department's advice to Government was more hard-hitting than advice originating elsewhere but, equally, the Department should have adapted the tone and content of its policy advice to the increasing vulnerabilities that were emerging.

A colleague and I prepared a paper for the senior management and the Minister in mid-2005 outlining the exposure of the public finances to a more severe correction in new house building.

The analysis showed that each 10,000 decline in new house building would reduce economic growth by around ½-1 per cent, increase unemployment by around ½ per cent and add just under €600 million to the budget deficit.

The paper, however, did not consider the financial stability implications of a large external shock interacting with the substantial correction in the housing market.

I also attach for the information of the Joint Committee, issues notes over the period 2004-2006 prepared by the Budget and Economic Division for its annual meeting with senior management. These notes demonstrate the escalation of the Division's concerns regarding the housing market.

R5c: analysis of the key drivers for budget policy

Studies of the Irish economy often present the years 2002 / 2003 as a watershed – the shift in the composition of aggregate demand from being export-led to being domestic demand-driven. The turn of the decade was also somewhat of a turning point for the conduct of fiscal policy.

In the years leading up to the beginning of the third stage of monetary union, the so-called Maastricht criteria imposed an important policy discipline in Ireland (and for some other Member States also). In terms of fiscal policy, the overarching requirements were to ensure a deficit below 3 per cent of GDP and a debt ratio 'close to' 60 per cent of GDP in order to ensure participation in monetary union from the outset.

However, it is fair to say that once Ireland became one of the founding members of monetary union, budgetary policy became less disciplined (and a number of economic studies confirm this).

One of the key drivers of budgetary policy was the political desire to fulfil public expectations for greater provision of public services as well as to lower the income tax burden. Indeed, an analysis of budgetary statements during this time clearly shows the premium placed on maximising the number of workers removed from the tax net as a result of discretionary income tax changes.

The Wright Report is very insightful in terms of its analysis of the drivers of budgetary policy highlighting, for instance, that the social partnership and other processes "*overwhelmed the Budgetary process….the Budget essentially paid the bills for these dominant processes*" (pg. 25).

Fulfilling the requirements of the Stability and Growth Pact was an important driver of budgetary policy at the time. The headline balance recorded surpluses in most years (and the debt ratio fell to very low levels) but, with the benefit of hindsight, it is clear that the public finances at the time were not build on strong foundations.

Measures of the underlying balance (the so-called structural balance – a key metric used in the Stability and Growth Pact) did not raise any red-flags either. In fact, even *ex post* the harmonised methodology that is applied across the European Union to assess the underlying fiscal position shows a structural surplus during most of the bubble years (the Department consistently pointed out the flaws in the methodology). In other words, Ireland fully complied with the rules of the Stability and Growth Pact during the bubble period, and this may have generated an unwarranted sense of security.

C1a: inter-departmental contact and the MoU with other EU Member States on the issue of banking

I can recall some discussions with the Department of the Environment on the issue of housing (although not on banking). These were mainly technical in nature – estimates of medium term demand, etc.

I was and remain the alternate (deputy) member of the Economic and Financial Committee of the European Union. The main role of the alternate member relates to implementation of the Stability and Growth Pact. Alternate members are also observers at European level discussions regarding banking and financial sector issues (e.g. banking union). None of these discussions related to any MoU with other EU Member States on the issue of banking.

5. Declaration

As outlined in section 4 (R5b), I am attaching four pdf files showing:

a) a note entitled "economic and fiscal implications of a reduction in housing output". This document has been sent to the Joint Committee on 28 January 2015 under Category 5, line of inquiry R3a.
b) the "issues note" prepared each year for the economic division meeting with the management committee of the Department. It is my understanding that these documents will be imminently provided to the Joint Committee by the Department of Finance.

I hereby declare that these documents are, to the best of my knowledge, true and correct. These documents are not in the public domain.

John McCarthy
27th May 2015