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Houses of the Oireachtas

Joint Committee of Inquiry into the Banking Crisis

Witness Statement of

Enda Kenny

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

Joint Committee of Inquiry into the Banking Crisis

Witness Statement

Taoiseach Enda Kenny T.D.

24/06/2015

Introduction

I am pleased to appear before the Joint Committee of Inquiry into the Banking Crisis following the issuing of direction pursuant to section 67 of the Houses of the Oireachtas (Inquiries Privileges and Procedures) Act 2013 by the Chairperson of the Inquiry Ciarán Lynch T.D.

It is the Government's hope that the Inquiry can generate new insights into the causes of the banking crash and related economic collapse that help policy makers ensure that the mistakes made at that time are never again repeated.

I have been asked to appear to outline my role as leader of Fine Gael between 2002 and 2007 specifically in relation to three areas:

- The effectiveness of the Oireachtas in scrutinising public policy on the banking sector and the economy;
- Analysis of the key drivers for budget policy; and
- Appropriateness of the relationships between Government, the Oireachtas, the banking sector and the property sector.

Economic Context

Prior to my election as Leader in 2002, Fine Gael was last in Government between 1994 and 1997, during which I served as Minister for Tourism and Trade. As a Government we secured modest public expenditure growth, budgeted for the first Government surplus in a generation and delivered a rapid reduction in Government debt, from 84% of GNP in 1994 to 64% of GNP in 1997. We secured Ireland's entry into Economic and Monetary Union and the adoption of the euro as our currency.

Economic growth averaged over 7% per year, driven primarily by strong growth in exports, which rose to 73% of our GDP – exceptionally high proportion by international standards.

We maintained a focus on manufacturing, exports and cost control in all areas. Between 1993 and 1997 inflation averaged approximately 2%, consistent with the maintenance of our international competitiveness. In the 1990s, Ireland doubled its share of the world export market. Foreign direct investment flows into Ireland increased significantly.

When my party left Government in 1997, we passed on an economy in which rapid growth was underpinned by sound public finances, strong productivity and employment growth and a vibrant export-oriented industrial base. Unemployment had dropped below 9%.

Having met all the necessary economic conditions to adopt the euro - a new, strong, stable currency with low interest rates to be used by 500 million people – the Irish people looked forward to building a more competitive, inclusive and innovative economy as a platform for long-term prosperity, stability and social cohesion.

Following the completion of the Economic and Monetary Union (EMU) and the formal circulation of the euro in 2001, the underlying dynamics of the Irish economy shifted dramatically in the following decade, particularly in the 2002-07 period and particularly with regard to the changed contribution to Irish economic growth from exports and domestic spending.

Most notable in this regard were the following developments:

- Significant tax incentives were introduced – and subsequently extended beyond the lifespan originally agreed - for property investment (multi-storey car parks, student accommodation, buildings used for third level education, hotels and holiday camps, holiday cottages, rural and urban renewal, park-and-ride facilities, living over the shop, nursing homes, private hospitals and convalescent facilities, sports injury clinics and childcare facilities etc.). All of these diluted the previous policy bias in favour of manufacturing and exporting activities.

- Public spending also became a major driver of economic growth, increasing by an astonishing €23 billion between 2002 and 2007 – a rate of growth that averaged 10% per year.

- Credit conditions, particularly for mortgages, also eased as banks began to borrow more cheaply from abroad under EMU, and there were no measures taken by the either national or European authorities to impose appropriate lending rules to protect economic stability generally, and young families buying their first homes in particular.

- Household borrowing more than doubled between 2003 and 2007, with Ireland becoming the second most indebted country in the eurozone by 2007.

- Ireland's current account balance – the difference between foreign earnings and foreign expenditure – went from a surplus of €1.9 billion to a deficit of €10.1 billion by 2007, as Irish households began to spend far more than they were earning.

- Our share of world trade began to decline significantly from 2002 as domestic cost inflation accelerated, with the loss of market share most acute in the manufacturing sector.

- From 2000 onwards, most new Irish jobs came from domestic – as opposed to exporting sectors – particularly the public sector and construction. Manufacturing and agriculture lost almost 50,000 jobs over the 2000-06 period.

- By 2004, the numbers of people working in the construction sector overtook – for the first time – the numbers of people working in the manufacturing sector. By 2006, the percentage of the workforce working in the construction sector was higher than any other industrialised country.

By 2007, an uncompetitive, bloated, over-borrowed and distorted Irish economy had been left at the mercy of subsequent international events, without the safeguards, institutions and mindset needed to survive and prosper as a small open economy inside the euro area.

By this point, the economic costs of the banking and wider collapse had already been incurred, even if the true scale of the disaster would take several more years to fully reveal itself.

Effectiveness of the Oireachtas in Scrutinising Public Policy on the Banking Sector and the Economy

As is evident from key speeches and policy documents dating from this period, under my leadership, Fine Gael – the main opposition party during 2002-07 – opposed the main strands of Government economic policy discussed above, and our Dáil members voted against the passage of every Budget.

Notable components of Fine Gael economic policy evident from this period were:

- Our opposition to the Government's changes to the structures for financial regulation introduced in 2002.

- Our warnings to the then Government regarding the deterioration in the country's international competitiveness, and in particular the rapid price and cost escalation taking place in the closed sectors of the economy. Our "Rip Off Ireland" campaign highlighted the growing divergence in price and cost levels for consumers and businesses between Ireland and our trading partners.

- Our regular demands for proper cost-benefit analysis to be applied to the proliferation of tax shelters and incentives, particularly for the property sector.

- Our campaigns to highlight the scale of Government waste of taxpayers' money as public expenditure escalated rapidly, most notably in our opposition to the Government's decentralisation plan. The "Buck Stops Here" set out Fine Gael's proposals for securing better value for the taxpayer in the delivery of public services and infrastructure.

- Our critique of the entire budgetary process, and the lack of opportunity for the Oireachtas to properly scrutinise and assess the tax and spending options available to the Government.

- Our opposition to the Government's public sector benchmarking pay deals, reflecting the lack of transparency and failure to link the deals to genuine changes in work practices and improvements in productivity.

A generalised critique of economic policy by Fine Gael during this period was that the then Government was abandoning the competitive, export-oriented, flexible economic model needed to prosper inside Economic and Monetary Union and that had been bequeathed to it by the previous Fine Gael led Government – an economic model built on sound public finances, high productivity and strong policy support for foreign direct investment and the "traded" sectors of the economy.

The ability of the Oireachtas to hold Government to account on the economy during this period was, however, hampered by:

- the bypassing of elected representatives as a result of the dominance of social partnership as the forum for influencing - behind closed doors - Government choices in all key policy areas;

- the absence at that time of a clear, national, statutory fiscal framework and expenditure rule to ensure sustainable management of the public finances, and the absence of an independent watchdog to police management of the public finances and to highlight risks;

- the absence of any requirement at that time to conduct and publish cost benefit analyses on tax shelters and major infrastructure projects and to subject all major expenditure programmes to regular review; and

- restrictions introduced to Freedom of Information.

Analysis of the Key Drivers for Budget Policy

Total public spending during the 2002-07 period increased by €23 billion. The average annual growth rate – at just under 10% per year – was roughly twice the underlying potential growth rate of the economy. The disastrous impact on the underlying health of the public finances was, of course, camouflaged by the temporary and unsustainable surge in transaction tax receipts from the credit fuelled construction and property bubbles.

The main political, social and economic drivers of the growth in Government expenditure over this period were:

- the genuine need to increase investment levels in physical infrastructure to address capacity constraints in the Irish economy and to support regional development, though it was clear even at the time that much of the investment was being wasted because of the absence of public sector procurement and project management expertise.

- the need for public sector salaries to chase the rising cost of living, which in turn reflected the uncompetitive and closed nature of many sectors of the Irish economy as well as the rising costs of public services. The rising size and cost of the public service should, of course, have been mitigated by a much stronger drive to secure public sector efficiencies, particularly in the health service with the amalgamation of the health boards into the HSE. This opportunity was lost as a result of the Government's public sector pay benchmarking deals.

- the doubling of the social welfare budget during 2001-07 at a time of rapidly rising employment. While there was a genuine need to reduce poverty levels among vulnerable groups (the elderly, children and the disabled), the rapid rise in payments to working age adults reflected the complete absence of activation reforms needed to lower the exceptional rate of jobless households in Ireland even at a time when the country was allegedly enjoying full employment.

- The absence at that time of a clear, national, statutory fiscal framework and expenditure rule to ensure sustainable management of the public finances, and the absence of an independent watchdog to police management of the public finances and to highlight risks. If the expenditure rule enacted by the current Government (which caps expenditure growth at the underlying potential growth rate of the economy) had been adhered to in the 2001-07 period, then spending growth would have been less than half the 130% increase actually incurred.[1]

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[1] Seamus Coffey, Economic Incentives, Blogspot, 2012

- The political cycle. Unconstrained by any independently policed set of credible fiscal rules, budgetary policy during this period was as a result driven by the needs of the electoral – rather than economic – cycle. Public spending without reform increased rapidly in the lead-up to the 2002 election (voted spending was up by 21% in 2001 and 14% in 2002), and in the lead-up to the 2007 election (up by 13% in 2007).

Not only would tighter management of public spending during this period have helped moderate economic overheating at a time of growing risk, but it would also have helped to leave the public finances in a much stronger position to protect living standards and the economy from the effects of the property bust and collapse in the construction sector.

It has, of course, been documented that the Fine Gael party, in its 2007 election manifesto, adopted broadly similar assumptions as the then Government about economic growth, tax receipts and public spending over the subsequent five-year Dáil term. These assumptions were drawn from contemporaneous projections by the Department of Finance and the Economic and Social Research Institute. Our assessment at the time was that these projections were credible on the basis of a steady, managed transition back to the competitive, export-oriented economic model that drove Ireland's strong and sustainable economic recovery during the 1990s.

Appropriateness of the Relationships between Government, the Oireachtas, the Banking Sector and the Property Sector

It has been alleged that a relatively small clique of bankers and property developers were able to bring influence on policy-making at that time to secure taxpayer support to favoured sectors and institutions. This is a matter of public interest for the Inquiry to pursue and I look forward to its findings.

Whatever the truth of the allegations, it is clear that there were features of Irish politics and the Irish policy making system at that time that left it vulnerable to such perceptions, most notably:

- The ability of Ministers for Finance to introduce – or extend – tax breaks for favoured sectors of the economy – and particularly the property and construction sectors - without published detailed assessments by the Department of Finance or scrutiny by the Oireachtas;

- The excessively close relationship between the Central Bank and the Department of Finance at that time, and between the Financial Regulator and the institutions it was charged with regulating;

- The ambiguity regarding the relative roles of the Central Bank and the Financial Services Regulatory Authority when it came to policing the stability of the banking system and protecting consumers and depositors;

- The corporate funding of political parties – to varying degrees – during this period;

- The dilution by the then Government of Freedom of Information;
- The absence of clear, enforceable rules regarding the jobs that could be taken up in the private sector by former Ministers, advisers and civil servants and the absence of any institution to police the resulting conflicts of interest;
- The lack of transparency and rules regarding the lobbying of public officials by special interests;
- The absence of effective planning regulation at that time;
- The absence of a structured, institutionalised national risk assessment process.

Conclusion

By meeting all the economic conditions needed in 1997 to adopt a new, strong, stable currency with low interest rates used by 500 million people, the Irish people dreamed of building a more competitive, globalised and innovative economy as a platform for long-term prosperity, stability and social cohesion.

For hundreds of thousands of Irish families, however, their dreams turned into a nightmare, as boom turned to bust and as stability was replaced by policy recklessness and regulatory failures.

To be sure, design flaws in the euro architecture as a whole contributed to the crisis here and elsewhere in the euro zone.

While much work remains to be done, these flaws are gradually being repaired.

But the lion's share of the damage to the Irish economy was the fault of domestic economic and financial mismanagement.

We have learnt the hard way that being part of the euro presents not just opportunities, but huge domestic challenges - the need for more effective regulation of the financial system, for greater budgetary discipline, for more responsible and transparent politics, and for relentless pursuit of cost reductions, innovation and product and labour market flexibility to maintain our competitiveness in the absence of any control over our exchange rate.

Having failed these challenges in the first fifteen years of our euro membership, our economic and political institutions are now being renewed and reformed so that the euro can once again become a source of stability, prosperity and hope for the Irish people.