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Joint Committee of Inquiry into the Banking Crisis

Witness Statement of

John McHale

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

John McHale

Chair, Irish Fiscal Advisory Council

Witness Statement to the Joint Committee of Inquiry into the Banking Crisis

July 2015

1. Could you briefly explain how you see your role as the Chair of the Irish Fiscal Advisory Council?

The core role of the Fiscal Council is to provide independent oversight of macro/fiscal forecasting and the macroeconomic dimensions of budgetary policy. The Council is therefore an important part of the new post-crisis budgetary framework of institutions, rules and procedures that has been put in place to support the sustainable growth of the Irish economy.¹ Combining complementary domestic and European elements, the framework should help ensure that the budgetary policy mistakes that have contributed to the vulnerabilities of the Irish economy in the past are not repeated.

The specific mandate of the Council has been set out in the Fiscal Responsibility Act (2012)² and the Ministers and Secretaries (Amendment) Act (2013)³. The Council shall:

- Monitor whether the Budgetary Rule set out in the Fiscal Responsibility Act is being complied with;
- Endorse, as it considers appropriate, the macroeconomic forecasts prepared by the Department of Finance on which the Budget and Stability Programme will be based;
- Provide an assessment of the official (macroeconomic and budgetary) forecasts; and
- In relation to each Budget and Stability Programme, provide an assessment of whether the fiscal stance for year or years concerned is, in the opinion of the Council, conducive to prudent economic and budgetary management, including with reference to the provisions of the Stability and Growth Pact.

Specifically in my role as Chair, I see my main functions as being: (i) leading in the development of consensus positions on our endorsements/assessments; (ii) being the main Council spokesperson in

¹ The elements of the new framework, including the specific roles of the Council, are usually described in the Government's Medium-Term Budgetary Framework document, available at: <http://www.finance.gov.ie/what-we-do/public-finances/medium-term-budgetary-framework-legislation/medium-term-budgetary>.

² Available at: <http://www.irishstatutebook.ie/2012/en/act/pub/0039/>.

³ Available at: <http://www.irishstatutebook.ie/2013/en/act/pub/0029/>.

explaining the Council's positions, including in the media and before the Oireachtas Joint Committee on Finance, Public Expenditure and Reform; (iii) together with Council colleagues, oversee the work of the Council's secretariat, including the preparation of reports and the development of analytical capacities; (iv) together with Council colleagues, ensure that all governance requirements for a statutory body are being complied with; and (v) to serve as Accounting Officer for the Council.

2. How does the Council go about reviewing and commenting on the Department of Finance's macroeconomic forecasts?

The Council is required to both assess and endorse, as appropriate, the macroeconomic forecasts underlying the annual Budget and stability programme. The endorsement process, which is underpinned by a Memorandum of Understanding with the Department,⁴ involves a number of steps. In broad outline, these steps are:

- Prior to receiving the Department's macroeconomic forecasts, the Council prepares its own benchmark forecasts for purposes of comparison;
- Approximately one month before the Budget/Stability Programme publication, the Council receives the Department's preliminary forecasts, which is followed by the technical presentation to the Council's secretariat;
- This is followed by a presentation by the Department to the full Council and secretariat of the updated forecasts, with an opportunity for members to query all aspects of the forecasts;
- The Council then meets to discuss the forecasts and to finalise a decision on endorsement;
- Any significant reservations are relayed to the Department;
- If the Council is satisfied that the forecasts can be endorsed, I write to the Secretary General of the Department providing our decision on endorsement;
- The endorsement decision is published together with the Department's forecasts in the draft Budget/stability programme.

In making its decision on endorsement, the Council considers: (i) the appropriateness of the forecasting methodologies used; (ii) evidence of systematic patterns of bias in recent forecasts; and (iii) deviations between the Department's forecasts and the Council's own benchmark and other available forecasts.

⁴ Available at: <http://www.finance.gov.ie/what-we-do/economic-policy/publications/reports-research/memorandum-understanding-between-irish>.

In our *Fiscal Assessment Report* subsequent to the Budget/Stability Programme, the Council publishes its benchmark forecasts and outlines both the process and the reasons for the endorsement or non-endorsement decision. To meet the assessment component of the mandate, the Council also provides an assessment of the Department's macroeconomic forecasts, which includes an assessment of current and prospective macroeconomic conditions.

3. How would you describe the level of support the Council receives from the Department of Finance? Could you comment on the quality and quantity of resource at the Department in respect of its macro-economic work?

The Council receives very good cooperation from the Department in its review work. All technical queries are dealt with promptly and detailed presentations – with ample opportunity to question the assumptions underlying the forecasts – are given to both the Council and the secretariat.

In our experience, under the leadership of the Chief Economist, the quality of the department's macroeconomic forecasting work is of a high level. As the Committee has been made aware in previous testimony from the Chief Economist, the Department's macroeconomic forecasting team has been significantly expanded compared to the pre-crisis period. I am informed by the Department that in the economic unit there is now approximately 20 people with a background in economics. Specifically on the forecasting resources, there are seven economists at the AP/AO level, with a further vacancy to be filled in the autumn. This compares with less than five people doing economic analysis/forecasting in the pre-crisis period.

One area highlighted in our most recent *Fiscal Assessment Report*⁵ in which the Department's forecasting capacities could be improved is in the production of medium-term forecasts of the potential growth rate of the economy. At present, the Department uses the harmonised methodology agreed between the Member States and the European Commission. The Department has itself repeatedly drawn attention to the limitations of this methodology for developing an adequate picture of the supply-side potential of the Irish economy. It is essential that the Government's forecasts are well-founded to provide a sound basis for ensuring that the public finances are on a sustainable path. The Council believes that this requires the development of a fuller picture of the supply side outside of the harmonised framework. To this end, the Council has recommended that the Department should also develop a set of medium-term baseline estimates

⁵ Available on the Council's website at: <http://www.fiscalcouncil.ie/fiscal-assessment-reports/>

for the supply side that are aligned to its forecasts for actual variables.⁶ This may require greater prioritisation of resources towards the development of such estimates.

4. Does the Council have sufficient resource to carry out its responsibilities? If not, how are seeking to fill any gaps?

The maximum budget of the Council was set in the FRA at €800,000, indexed to the Harmonised Index of Consumer Prices (HICP). The maximum level was €820,000 in 2014. The Council has a full-time secretariat of five, comprising a Chief Economist/Head of Secretariat, two economists, one research assistant, and an administrator. The Chief Economist and one economist are currently on secondment for the Central Bank and Department of Public Expenditure and Reform respectively. Our administrator is on secondment from the Department of Arts, Heritage and the Gaeltacht. Each year our budget has been below the maximum level (€606,000 in 2014), although the gap has been narrowing as capacity has been put in place. With the caveats noted below, I believe we have adequate resources to fulfil our mandate.

We have the necessary resources to produce our own benchmark macroeconomic forecasts and to endorse/assess the Departments forecasts, to fully assess compliance with the domestic and European rules and to provide the required normative assessments of the policy stance.

Although we do have the resources to provide basic assessments of the budgetary forecasts, we do not have the resources to produce a full set of our own benchmark budgetary forecasts. An argument could be made that a full assessment of such forecasts requires the capacity to produce our own benchmark (as we already do on the macroeconomic side for the endorsement exercise). However, the independent production of a full set of budgetary forecasts is a resource-intensive exercise, the requirements of which exceeds our current capacity.

Within our existing budget cap, we are endeavouring to build capacity in this area. We have made significant advances in the ex ante and ex post analyses of tax forecasts, and are currently building capacity for medium- and long-term expenditure forecasts, including the incorporation of demographic drivers. We are exploring improved information access with the Departments of Finance and Public Expenditure and Reform and also with Revenue. We are also beginning the process of hiring an additional research assistant, whom would be dedicated to the budgetary forecast assessment task.

⁶ Use of the harmonised framework is required for European fiscal surveillance purposes.

Compared to the legislation establishing independent fiscal institutions in other countries, the Fiscal Responsibility Act does not provide the Council with a statutory right to information. Such a right is also one of the principles identified by the OECD for best practice for independent fiscal institutions.⁷ Although we receive good cooperation in accessing the information we require from Government – and further improvements could be achieved with appropriate Memoranda of Understanding – providing such a statutory right should be considered in any review of the legislation underpinning the Council.

5. How do you ensure that the Council carries out its work independently of Government?

The Fiscal Responsibility Act contains a number of provisions that support the independence of the Council. Most importantly Section 8(1) explicitly states that “the Fiscal Council shall be independent in the performance of its functions.” This is backed up by a number of provisions that limit the Government’s ability to sanction the Council for inconvenient assessments. These include: (i) limits on the Minister’s ability to remove a member to explicitly stated grounds; (ii) a requirement that “a member may not be removed . . . unless a resolution for the removal and stating the grounds for it is passed by Dáil Éireann;” and (iii) the budget of the Council is paid directly out of the Central Fund.

At a more practical level, the Council endeavours to operate at arm’s-length from the Minister and the Department of Finance. This is to minimise any risk of intellectual capture. Interactions with the Department are usually undertaken by the secretariat and limited to technical matters. Formal meetings between the Council and the Department are typically limited to the formal presentations of the Department’s macroeconomic forecasts as part of the endorsement process for the Budget and Stability Programme.

6. What role, if any, do you see for the Council in any future financial stability crisis, and how would this work?

Given the arm’s-length relationship noted above and its public reporting role, it is unlikely that the Council would be involved in providing closed-door advice on crisis-management policies. For this reason, even if the Council had existed in 2008, it is unlikely, for example, that it would have been involved in deliberations on the night of the bank guarantee. However, since its establishment in 2011, the Council has, in its public-reporting role, provided analysis of the budgetary aspects of crisis-resolution policies. Moreover, when necessary, the Council can produce analysis in a short

⁷ These principles are available at: <http://acts.oecd.org/Instruments/ShowInstrumentView.aspx?InstrumentID=301&InstrumentPID=316&Lang=en&Book=False>.

time period outside of its regular reports. A recent example is the publication of a note on anomalies relating to the expenditure benchmark.⁸ The period from conception of the note to its publication was less than three weeks.

7. What did you intend to achieve when you took up the role and what would you say you have actually achieved to date?

The Council was established in the midst of the crisis in the summer of 2011. Notwithstanding the official assistance programme, the yield on 8-year sovereign bonds reached close to 15 percent in July 2011 and a standard measure of the implied probability of default over the subsequent 8-year period reached over 85 percent. Significant uncertainty existed over the prospects for economic growth, the ultimate size of bank losses, and the evolution of Eurozone crisis-resolution policies.

A major focus of the Council in its early years was thus inevitably on how fiscal policy could contribute to the resolution of the crisis. The Council supported the broad thrust of Government policy to ensure that the conditions for official assistance were met, the debt put on a sustainable path and a costly sovereign default avoided. Such a default would have delivered another twist to the vicious feedback loops between the sovereign, the banks and the real economy that characterised the crisis. A key element of crisis-resolution policy – what is sometimes referred to as “catalytic finance” – was to convince private investors that they would not face default, thus catalysing re-access to sovereign debt markets at affordable rates.

In formulating its advice on the appropriate pace of fiscal adjustments, the Council was cognisant of the trade off between minimising the contractionary effects of fiscal adjustments on an economy already in deep recession and a return to creditworthiness and debt sustainability. Weighing these factors, part of our early advice was to plan for additional (back-loaded) adjustments beyond those planned to ensure that key programme and Excessive Deficit Procedure targets were met, thereby assuring potential investors that they faced a low risk of losses on Irish debt. Given the political costs of such adjustments, I did not consider it especially likely that such advice would be heeded, but I believed it was important for investors to see that the Council supported the catalytic finance strategy of ensuring conditions for official assistance were met and default avoided. Ireland’s successful exit from the programme, return to sovereign debt markets, and – crucially – its return to growth and debt sustainability, convinces me that the broad catalytic finance strategy followed was the correct one. Although I certainly wouldn’t exaggerate the Council’s role, this success was what I

⁸ The Analytical Note is available on the Council’s website at: http://www.fiscalcouncil.ie/wp-content/uploads/2012/01/ExpenditureBenchmarkNote_310315_Final_1.5.pdf.

had strongly hoped for as we grappled with the appropriate fiscal response to the crisis in those difficult early days.

With the successful exit from the official assistance programme, the Council's attention has turned to the prevention of future crises and establishing the conditions for sustainable growth in income, employment, revenue and expenditure. As noted earlier, a major accomplishment of recent years has been the institutionalisation of a strong budgetary framework comprising mutually reinforcing domestic and European elements. The Council plays a central role in this new framework through its endorsement and assessment functions. A major focus has been to inform the public about the framework, not least its value in ensuring we avoid the type of pro-cyclical fiscal policies that created such vulnerabilities in the past. While building support for the framework is a work in progress – hopefully something that can be furthered by Inquiry's work – I believe that the strengthening of the framework that has been achieved will stand the country well.

At an institution-building level, a key goal was to establish a fit-for-purpose and respected organisation to serve the country over the long term. Through our excellent secretariat, we have put in place the necessary analytical capacities to deliver on our mandate. We have also adopted all the governance requirements for a statutory body, and, I hope, established the Council as a trusted voice in the public discussion on budgetary matters.

8. Are there any improvements you would recommend to the operational elements of the review work? If so, how might these be implemented?

In 2014, the Council initiated a peer review of our operations by a panel of experts chaired by the former head of the Swedish fiscal council, Professor Lars Jonung. The panel's report was finalised in June 2015.⁹ In addition to the value of expert feedback, the Council viewed the review as central to our accountability. This takes on even more importance given our statutory independence. The report was generally positive on the operational performance of the Council, concluding:

“Our overall assessment of IFAC is a positive one. IFAC has fulfilled all the tasks that are expected from an independent fiscal institution. It has been independent, credible and non-partisan; it has created a brand-name; its outputs are well-regarded; and it has been visible in public debate, increasing transparency and public knowledge about fiscal matters. IFAC is well integrated in the EU framework for fiscal surveillance. These achievements

⁹ The report is published on the Council's website and is available at: http://www.fiscalcouncil.ie/wp-content/uploads/2012/01/PeerReview_Formatted_23062015.pdf.

augur well for the future, but there is also scope for enhancing the output and impact of the Council.” (p. 33).¹⁰

The report makes a number of valuable suggestions for improving the operational performance of the Council under the headings of: mandate, output of IFAC, the impact of IFAC and its communication strategy, and the EU framework and the Irish Fiscal Framework.

Among the suggested operational improvements are:

- Putting more emphasis on long-term fiscal issues, such as debt sustainability;
- Developing shorter, more popular versions of reports which convey the key messages but offer links to more detailed material; and
- Developing its analytical capacity on issues pertaining to the EU framework of fiscal surveillance such as the output gap, taking account of the specific nature of the Irish economy.

The Council is currently developing a plan to implement the findings of the review, with many of the operational improvements already being progressed.

¹⁰ Jonung, Lars, Iain Begg, and Michael G. Tutty (2015), “How is the Irish Fiscal Advisory Council Performing? An Independent Evaluation of the First Years of IFAC,” Dublin: Irish Fiscal Advisory Council.