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Houses of the Oireachtas

Joint Committee of Inquiry into the Banking Crisis

Witness Statement of

Michael McGrath

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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

Pursuant to Section 67(1)(d) of the Houses of the Oireachtas (Inquires, Privileges and Procedures) Action 2013.

Michael J. McGrath
Assistant Secretary

3rd August 2015

Introduction

Further to the Direction by the Joint Committee of Inquiry into the Banking Crisis, I submit the following written statement to a series of questions that the Joint Committee has put to me under a range of "Themes" and "Lines of Inquiries". I have been directed to make a statement in writing in relation to my role as Assistant Secretary, Budgetary, Economic and Pensions[1], EU Policy Coordination and all relevant roles in the Department of Finance. The comments offered in this statement relate solely to my time and experience while working as an official in the Department of Finance. None of my comments relate to my experience gained since going on special leave from the Irish civil service.

Background

Following a public recruitment process specifically targeted at hiring economists, I joined the Department of Finance as an Administrative Officer (Economist) in 1990. I worked as a junior economist dealing with macro economic forecasting issues - both short and medium term, until spring 1994. Then, for a sixteen-month period, I went on secondment to the National Economic and Social Forum as the Forum's Economist. I returned to the Department of Finance in 1995 and worked, initially as an Administrative Officer and then as an Assistant Principal, on fiscal policy and economic matters for about 8 years in total. In 2003, following a competitive process, I was appointed as Principal Officer in charge of the IFSC and International Taxation Section within the Budget and Economic Division, where my focus was on tax policy matters. In March 2007, following an external competitive selection process, I was appointed the Head of the Economic and Fiscal Policy Unit (Assistant Secretary). As Assistant Secretary my responsibilities were:

- March 2007 - May 2012: Assistant Secretary with responsibility for the formulation of budgetary and economic policy advice and EU policy coordination;
- October 2009 - mid-November 2011: In addition to the above duties, during this period I also had responsibility for Ireland's membership in certain International Financial Institutions, such as the World Bank and IMF.
- May 2012 - July 2014: I was the Assistant Secretary for the EU Division with responsibility for EU policy coordination - the Irish presidency of the EU during 2013 was a primary focus.

As Assistant Secretary, I reported to the Second Secretary General in charge of the Budget and Economic Division, who in turn reported to the Secretary General of the Department of Finance. My functions and responsibilities were in line with the overall Department's Statement of Strategy and specified in the annual Business Plans submitted to the Management Advisory Committee (MAC). During my 24 years working in the Department I worked as an economist at all levels dealing with economic, budgetary and fiscal policy matters, both in a domestic and international context. At end-July 2014 I went on special leave from the Department for a 3 year period.

[1] During my time in the Department of Finance and, in particular as Assistant Secretary heading the Division dealing with economic, budgetary, EU and international policy issues, the title for the Division changed a number of times. One such title for the Division was "Budget, Economic and Pensions Division".

R1a - Appropriateness of Regulatory Regime

Q. 2 From the evidence put before the Joint Committee by DOF, no notes or analysis were prepared on the banking sector, or the strong credit growth in the banking sector, during the period running up to the crisis. Was this, in hindsight, a mistake, or are you aware of any such analysis?

Q. 3 Please describe the general nature of the advice, if any, that the Department of Finance provided to the Minister and Government on the risks involved, especially the growing dependency on construction-related economic activity and tax revenues? Refer in your response to the frequency of such advice and the nature of supporting analyses.

Response
I propose to take these two questions together.

First and foremost, the Department of Finance did not have a direct role in the monitoring of the banking sector, as this responsibility rested with the Financial Regulator which was under the overall Central Bank architecture. Furthermore, the pursuit of the appropriate monetary policy stance and macro prudential policy is a matter for the Central Bank[2].

Since the advent of economic and monetary union (EMU) and the adoption of the Euro as the Irish currency, the importance of money supply, including the supply of credit within a region of EMU, and the importance of the balance of payments financial data was not given sufficient consideration by economists generally throughout the Euro zone. A view within the economics profession had developed that imbalances within a currency union were not macro-critical as would be the case in a country responsible for its own monetary policy. This proved to be an incorrect view.

The Budget and Economic Division did not analyse credit developments, merely reporting instead on emerging trends and commenting upon how these trends were lining up in the context of the macroeconomic forecasts periodically produced by the Division and presented to the Minister and Government before publication. Notwithstanding the fact that macro prudential policy was the responsibility of the Central Bank, it is now clear that it was an oversight on the part of the Department not to consider such matters in formulating the Department's policy advice.

As the crisis was unfolding and certainly in relation to my time as Assistant Secretary, the Budget and Economic Division's focus was concentrated upon macroeconomic and budgetary matters, i.e. analysing options and offering policy advice on general macroeconomic and fiscal policy, as opposed to providing sectoral economic and monetary policy advice.

In terms of advice given to the Minister and the Government on the risks associated with the "growing dependence" on construction, a number of my colleagues - both serving and retired - have in their public written evidence set out in detail the nature of the risks identified by the

[2] See speech by Deputy Governor of the Central Bank, Mr Stefan Gerlach at an ESRI Conference on *"Financial Stability after the Crisis"* 29th February 2012. In the speech the Deputy Governor stresses the independent role of the Central Bank.

Department. While not wishing to repeat what others have said, the Joint Committee may wish to take note that risks relating to price developments and the impacts on wages, affordability, cost of doing business and thus overall economic competitiveness were regularly identified as being domestically generated risks to economic wellbeing. The negative impact that the construction sector was having on wage developments, labour supply elsewhere - crowding out in particular within the manufacturing sector - and the significant dependence on fiscal revenues coming from the sector were all identified. This led to the Department's pre-budgetary advice being consistently one of advocating a tighter fiscal stance - less increases in Government spending and/or less reductions in taxes or use of tax reliefs - than that ultimately pursued as Government policy in the subsequent Budgets. The Wright Report[3] conducted an analysis of various budget strategy memoranda and subsequent budget day announcements and found this to be the case.

The normal "vehicles" by which the Department would have signaled such risks would have been, inter alia; (i) the Budget Strategy Memorandum; (ii) the periodic presentations of the Department's macro economic forecasts to the Minister and Government, (during my time as Assistant Secretary of the Budget and Economics Division there was an increase in the production, publication and presentation of the macroeconomic forecasts[4]); (iii) the monthly and quarterly notes to the Minister on the Exchequer returns and associated quarterly press conferences which I chaired; (iv) as well as other periodic notes prepared by officials on key Central Statistics Office economic indicators, such as the CSO's Quarterly National Household Survey.

All that said, I fully concur with the findings of the Wright Report, and others, who noted that while the Department did highlight risks and made warnings, the Department did not escalate the warnings as time went on, thus leading in general to the warnings being devalued or ignored. I believe that since the Wright Report, the Department has addressed the relevant recommendations and has supplied a document (ref: DOF02844) to the Committee which outlines the status of those recommendations which have largely been implemented.

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[3] "Strengthening the Capacity of the Department of Finance – Report of the Independent Review Panel" – known as the Wright Report.

[4] For instance a mid-year technical update to the macro-economic forecasts was published alongside the mid-year Exchequer returns on 2nd July, 2008. As part of the process, I presented this technical update to the media at the July Exchequer Returns press conference.

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

Q. 4 In your opinion were staffing levels at the department during your tenure at the Department of Finance adequate or not? Was there a retention problem, or problems finding replacements for suitably skilled staff, during your tenure?

Response

Based on my experience as Assistant Secretary and, in particular, when I was the Head of the Economic and Fiscal Unit, I would make the following observations:

- As a fact, overall resources within the Department were heavily constrained during the crisis. However, this must be seen in the context of the very buoyant labour market for economists in the private sector during the pre-crisis years; the necessary restrictions on both numbers of staffing and pay rates once the crisis took hold in 2008.

- Furthermore, as the Banking crisis deepened all Divisions within the Department released resources to ensure that the newly created Banking Division was adequately resourced. The ability of senior management to implement this rapid re-organisation at a time of crisis was a testimony of the flexibility of the staff who took up new or additional duties without any dispute. However, as a consequence of the reorganisation all other Assistant Secretary areas had to operate with fewer numbers of personnel.

In terms of bolstering the economic resources available to me during my time as Assistant Secretary and Head of the Economic and Fiscal Policy Unit, I would like to draw the Joint Committee's attention to the following facts:

- I sought the redeployment to my Division of 2 Principal Officers with economic skills from elsewhere within the Public Sector.
- I made arrangements to retain an additional economist from the Central Bank so as to assist the existing senior economist already on secondment from the Central Bank. I also subsequently advocated for the retention of the senior economist at the grade of Principal Officer while remaining in his role as the Department's senior economist.
- In order to deepen our understanding of other international organisations, I also facilitated the secondment of a number of officers to positions abroad on a temporary basis and I was very happy to see them subsequently return with enhanced skills set.
- I also worked with the ESRI to deepen our engagement with that Institute and improve our use of their technical resources such as the HERMES Macro economic model.
- During my time as Head of the Economics Division, I facilitated the further education of officers, with at least one officer continuing to study towards a relevant PhD in the area of macroeconomic modeling.
- Finally, on this point, I would like to note that my management colleagues at the Management Advisory Committee (MAC) were supportive of the steps that I took to maintain and enhance the skill levels of the staff in the Budget and Economic Division.

Stepping back from the crisis years, I believe that for the Department of Finance to operate effectively it is critical that the emphasis, in terms of qualifications both academic and applied, is largely placed on economic, business and/or financial qualifications given the subject matter that most officials deal with. Taking that into account I believe that the traditional general recruiting model, as would have been the norm in the past, is not now appropriate for the Department. Regular economic and financial graduate entry to the Department is critical so as to ensure that fresh and up to date thinking is being availed of within the policy formulation units of the Department. Also, greater use of atypical working arrangements, secondments/placements with other organisations, both nationally and internationally, offer an outlet for continued up-skilling of the Department's core staff and should be frequently used. Ensuring that the vast majority of staff, at all levels, within the Department have the necessary up to date economic and financial skills is essential. This is particularly so when dealing with fiscal, monetary and banking policy advice formulation, as such skills are not solely relevant for those individuals working in the Budget and Economic Division.

Developments such as the Government's new economic service (IGEES) along with the ability of Departments to directly recruit to fit their own skill needs will further assist in this matter.

In summary, I believe that economists and staff with economic, business and financial backgrounds have a significant role to play throughout the organisation at all levels. While this may not be the view of others, based on my own personal career experience, I believe that continuing to operate as an economist is not an impediment to career progression within the Department.

Finally, under this heading, the Joint Committee brought to my attention an article written by Dr. Garret Fitzgerald (January 2009) where he noted that there were no or little economists in the Department. This article was not the first time that Dr FitzGerald had made such claims. I can recall an earlier article in the Irish Times on 24th August 2002 where he referred to *"the disappearance – for whatever reason – of economists from the assistant principal grade in the Department of Finance"*. In relation to both of these articles, I believed that it was important for those economists working within the Department that the Department responded to Dr Fitzgerald's comments. In this regard, I would draw the Joint Committee's attention to papers relating to both the 2002[5] and 2009 articles, the latter of which has already been sent to the Committee (Ref: DOF07433), which sought to clarify matters for Dr FitzGerald and the Irish Times readers.

[5] See letter from Ms Carmel Keane, Head of Corporate Services Division (CSD), to the Irish Times Editor, 3rd September, 2002.

R2b - Nature and effectiveness of the operational implementation of the macro economic and prudential policy

Q. 6 Was there clarity in the roles and accountabilities for managing financial stability issues in the period 2003 to 2008, during the crisis and post 2010? In your opinion, what were the responsibilities of the Department of Finance in this process?
Q. 7 The Central Bank's Financial Stability Reports were flagging risks (such as rapid house price inflation, escalation of lending to fund commercial property etc.) to the financial system as early as September 2004. What action, if any, was taken by the Department of Finance in response to these reports?

Q. 8 During your tenure at the Department of Finance, were any internal analyses undertaken of the growing dependency on property-related tax revenues? Was the matter discussed at management board level, if so, how frequently and what was the general outcome?

Q. 10 In your recollection, what were the reasons for the CBFSAI Board/Department of Finance in favoring a soft landing scenario for the property market over a hard landing? Were these reasons ever discussed in detail? Honohan points out that the FSR cites no quantitative analytical evidence for this conclusion.

Q. 11 Was the Department of Finance ever asked (and by whom) to undertake studies on the effects of the strong credit growth of the banks on the financial stability of the State?

Response
During the period 2003 to Spring 2007, I was working on corporate and international tax matters and had no direct involvement in these specific Lines of Inquiry. Consequently, I am not aware of matters that may have been flagged to the Financial Services Division of the Department of Finance in the context of considering the Financial Stability of the Irish financial sector or any actions that may have been taken. That said, in terms of the issue of financial stability, the Central Bank is independent on a statutory basis. It has responsibility for the monetary policy role as well as having responsibility of ensuring the financial stability of the State's financial system, given its overall responsibility for the supervisory/regulatory regime. As such the Department of Finance is the primary body that advises on macro economic and fiscal policy. In relation to analysis of strong credit growth, I am not aware of any requests that were made to the Department to conduct an analysis of the impact of such credit growth on the financial stability of the banking sector or the State.

Regarding the issue of the growing dependency on property related tax revenues, I note that there were a number of reviews conducted on the role and use of property tax reliefs. In 1996, a detailed study was undertaken by KPMG with its primary focus on reviewing the efficacy of the various urban renewal schemes. In the late 1990s there were a series of reports – known as the Bacon Reports – which looked specifically at the housing market and made a number of recommendations. Many of these recommendations – including the removal of the deductibility of interest on borrowings for investment property purchase – were included in subsequent legislation – see Finance (No.2) Act 1998. However, later on in the Finance Act 2002, I recall that further changes were made to the tax treatment of investment in property including the rowing back on some of the earlier restrictions. While not specifically involved in these later issues, I recall that during the 2000's other studies were conducted and property restrictions were introduced within the tax code. My understanding of the reason for the introduction of such restrictions was to address property related overheating and unintended use of various tax concessions.

All during this period, the annual Tax Strategy Group process would have considered the role of housing and the tax treatment of same. I understand that these papers are publicly available on the Department's web site.

By the time that I took up my role as Assistant Secretary/Head of the Economic and Budget Division, the focus had shifted towards the initial weakness and ultimate significant decline in the revenue base largely associated with property transactions. In that context the MAC and the Minister were regularly informed of the emerging picture, for example by the monthly and quarterly notes to the MAC and the Minister on the fiscal situation, the incoming brief prepared for the new Minister (May 2008), assessments of the relevant Programme for Government as well as the various budget and economic related memos prepared for the Minister and Government of the day.

In terms of the prevailing thinking that the growing housing market would revert to a more medium term sustainable level in an orderly fashion – the so-called "soft landing" scenario – it must be acknowledged that this was very much the orthodox thinking of most economists at the time. The basis of official forecasts from the Department, the Central Bank, the ESRI and other international bodies was that the soft landing scenario would prevail.

The central building block for the Department's housing analysis was heavily influenced by the annual review conducted by the Housing Department within the then Department of Environment and Local Government. The Annual Review, conducted by that Department with the technical assistance of an external economics consultancy firm would have set out the likely outlook for the overall construction sector for the medium term. That outlook, while having specific focus on completions and price developments for both the residential and commercial sectors, did not foresee a collapse in construction activity. While this analysis along with the internal analysis on the slow-down in new house construction was incorporated into the Department's central scenario – which saw a reduction from the then peak of house building – it must be noted that for the following few years housing output and prices continued to outstrip what was then thought of as the medium term sustainable level before ultimately collapsing.

Work had also been conducted within the Department a few years earlier to assess the impact of a fall of 10,000 units on economic activity and the fiscal position. There was not any consideration of possible negative feedback loops into the financial sector from a fall in housing output and price. Thus the scope of that analysis was narrow and, like others within the economics profession, could have been more beneficial had it considered the wider issues.

However, by the time that I took up my position as the head of the Economics Division, the central scenario of the "soft landing" hypothesis was firmly ingrained in the Department and elsewhere. While with hindsight, this thinking should have been challenged more robustly, I would point out that the "soft landing" scenario was very much the thinking of the vast majority of the economics profession - a clear and regrettable example of "group think" by the economics community.

R2b - Nature and effectiveness of the operational implementation of the macro economic and prudential policy.

Q. 9 During his Hearing in the Context Phase of this Banking Inquiry, Prof. Fitzgerald said: "There was a cultural change in the Department of Finance in the last decade. It became more concerned about the politics of things and less interested in the technical detail. I would have had less interaction." Would you like to give us your own view on these comments?

Q. 12 Could you describe the nature and extent of the co-operation and exchange of information between economists in the Department of Finance with colleagues in the Central Bank, ESRI and other external economic forecasters during your tenure at the Central Bank/Department of Finance?

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

Q. 15 Each year, the Governor of the Central Bank would issue a pre- budget report to the Minister for Finance known as the "Governor's Letter". Should the Governor's Letters or any other reports from the Central Bank always be taken at face value and not subject to challenge from within Dept of Finance? What processes does the Department of Finance have to challenge information provided to it by the Central Bank?

Response
I propose to take these three questions together.

During my time as Assistant Secretary I believe that the level of engagement between the Department's Budget and Economics Division and both the Central Bank and the ESRI deepened and was cooperative and business like. In this regard, I point to the following:

- I personally worked closely with both organisations and encouraged freely flowing communication on economic matters.
- Having regard to the independence of both institutions, the Department had an opportunity to comment on drafts of both Central Bank and ESRI economic reports and took the matter very seriously. After consulting within the Department, the Budget and Economic Division always supplied technical and policy related comments for the relevant institution to consider as appropriate.
- I initiated policy dialogue with economists from both organisations thus, facilitating a sharing of views so that the policy advice that my Division offered both the Department's MAC and the political system (Minister and Government) benefited from as wide a consideration of the issues as possible. I also engaged regularly with private

sector economists and organised round-table events with academic, institutional and private sector economists to discuss key economic matters. At one such event I arranged for a senior EU Commission official to present and participate in a wide ranging Chatham House style discussion on Irish economic developments.

- Officials from both the Department and the Central Bank are members of a variety of EU committees (both working groups and policy groups), such as the Economic and Financial Committee, Euro Working Group and the Economic Policy Committee. In addition Central Bank officials would also have attended with me various senior economic policy committees at the OECD. I personally engaged with such individuals regularly so as to ensure that the presentation, at the relevant EU and OECD committees, of the Irish case/viewpoint benefited from as much institutional shared wisdom as was possible. I believe that this is still the practice today.

In terms of the specific views of Professor Fitzgerald that have been highlighted to me by the Joint Committee, I offer the following personal view. During my tenure as Assistant Secretary of the Budget and Economic Division I had a number of engagements with the ESRI at Director and senior staff level. All of these were conducted in a professional and business-like manner and either focused on the ESRI's grant-in-aid (funding from the Government) or the various technical economic and fiscal issues of the day. I specifically recall technical discussions around the time of the ESRI's 2008 Medium Term Review with Professor Fitzgerald on the nature and character of the economic and fiscal downturn. The strongly held view of the Department, based on the work that we had done within the Budget and Economic Division, was that the fiscal deficit was mainly structural in nature and as such would not be very responsive to any resumption in the economic cycle. As such, the Department had a very different assessment of the impact of the balance sheet recession on consumers, i.e. that the savings ratio would remain at its historical high level and that a substantial element of the rapidly rising numbers unemployed would require various active policy measures. This analysis led the Department to offer advice in terms of the scale and nature of consolidation that should be pursued. This advice was different from the advice offered by Professor Fitzgerald and some others at the time. I believe that the advice offered by the Department was the correct policy advice to pursue at that time.

In relation to the view that the Department was more concerned in the "politics of things", I must respectfully disagree. The Department offers policy advice to the political system and in particular to the Minister and Government of the day. In doing so the Department has to offer its policy advice while been conscious of agreed Government policy and other relevant factors such as the agreed Programme for Government and other agreements such as those made under Social Partnership during that period. That said, where the Department feels that previous policy commitments are no longer tenable the Department has, in my experience, highlighted such matters to the Minister and Government of the day[6].

Finally on the point made that the Department was *"more concerned about the politics of things and less interested in the technical detail"*, I would also highlight that during my time as Assistant Secretary of the Budget and Economics Division, it was very clear that the

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[6] See Note from the Secretary General to the then Tánaiste and Minister for Finance on the then Government's Programme for Government – 29th April, 2008

macroeconomic and fiscal forecasts that underpinned the various policy events, such as the Budget and the Stability and Growth Programme Updates, were those of the Department. This independent role of the production of the fiscal and economic forecasts by the Department is a longstanding role.

In relation to the Governor's letter, first of all I note that the focus was on the macroeconomic and fiscal outlook and not on the financial macro-prudential aspects of the economy. This was not surprising given that the Governor would have been writing in the context of the forthcoming budget. The Governor's letters were considered by the Department in the overall context of the formulation of budgetary policy advice. Furthermore, I believe that the Department was sufficiently well resourced to analyse the contents of the annual letter and during my time this was done. I have no reason to believe that the practice has changed since I changed responsibilities in mid-2012.

R4a - Appropriateness of expert advice sought, quality of the analysis of the advice and how this advice was used.

Q. 17 According to the document provided, very little external advice was sought or obtained on specific areas of economic development by the Department of Finance, for example the development of the banking sector, or the dependency of the economy on the construction sector. Could you explain why was no external advice requested?

Q. 18 Concerns over the state of the housing and construction industry were voiced in some speaking notes and internal comment papers within the Department of Finance in as early as in 2003. Were you aware of staff members that brought up these concerns, and do you have an opinion on whether those concerns should have been handled differently?

R4c - Analysis and consideration of response to contrarian views (internal and external).

Q. 19 Morgan Kelly published an article on a potential house price bubble in the Irish Times end of 2006 and later published a report on the same theme as part of the ESRI bulletin in summer 2007. Can you recall if any discussions were held at Senior Management level in Central Bank/Department of Finance afterwards? Were Morgan Kelly's concerns given serious consideration?

Q. 20 Were you aware of any contrarian voices inside the Department of Finance in relation to the Property inflation issues or the issues in the Banking System, and would you want to elaborate on this?

Response

As I was neither a member of management nor working in the Economic or Financial areas of the Department during the time period in question, I am not in a position to comment regarding any concerns expressed or advice sought during the mid-2000s on specific areas of economic development such as the development of the banking sector or the dependency of the economy on the construction sector.

When I became the Assistant Secretary in charge of the budgetary and economic policy matters, my focus was on the macro economic and fiscal issues of the day. Shortly after taking up the role, the issue of the rapidly slowing economy, the effective "hard stop" in construction activity and the deteriorating fiscal situation fully concentrated the efforts of all within my Division.

In the context of the Department seeking external advice, the Joint Committee has provided me with a document that sets out a schedule of "external non-legal advice sought that was sought by the Department of Finance on the banking sector and the macroeconomic view during the period 2001-2010. In terms of the list provided, I note that it appears to me to relate solely to consultations that colleagues would have conducted on the Financial Services Division in relation to various EU directives. In relation to matters pertaining to the Budget and Economic Division, I have already noted the various forms of external outreach that I, and my Division, conducted. In addition, to the various domestic reports from the Central Bank and the ESRI, the Budget and Economics Division would have been in receipt of various international reports, notably from the EU Commission, the OECD, the IMF, the ECB and various other international central banks, international think tanks (e.g. Bruegel – based in Brussels and which the Department part funded). Also the Division would also have received various reports from the NTMA and the global Rating Agents – who tended to engage directly with the Division and would meet with key staff including me. On top of these various reports, I would also highlight that other periodic consultancy reports from both domestic and international economic consultancy would have been submitted to the Division and the analysis of same would have been considered. Finally, on this point, in the context of the annual budget, the Department and in particular the Budget and Economic Division would have received a significant amount of budgetary and economic analysis submitted by external bodies. Consequently in my view, the Department was not short of macroeconomic views and advice from external bodies. Regrettably such external advice did not predict the crisis until it was far too late to have altered policy advice in time to have satisfactorily addressed the emerging crisis.

In terms of differing views within the Department during this time period, again I am not in a position to address this point with specifics as I did not work on these matters at the relevant time. However, I would say that in my time working in the Department of Finance, the environment was conducive to staff offering views in a variety of fora and I personally did so at all levels. Obviously, from these varying opinions/views expressed it is the work of the relevant officers to craft together a sensible, credible and plausible set of views in relation to how the macroeconomic and budgetary outcome is likely to evolve. It is important to note that macroeconomic and budgetary forecasting is not an exact science, at all times judgment is required in the analysis and presentation of the emerging trends. Thus in the production of any set of forecasts, there will be differences of views.

During my time as Assistant Secretary, I encouraged an open dialogue and fostered debate in terms of policy matters. I operated an open-door policy and encouraged my senior managers working to me to do likewise. Specifically in relation to the production of the macroeconomic forecasts, I actively encouraged the forecasting staff to engage with others so as to ensure that we produced a credible and robust forecast that would stand up to comparison and criticism. Staff would have presented their preliminary findings to colleagues within the Department (not just the Division) and were encouraged to analyse the ensuing feedback from such challenge sessions, thereby making the final forecast more robust. The Division also periodically presented initial findings to our colleagues in the Central Bank on an informal basis and would have had similar discussions with the ESRI short term forecasting team.

In terms of Mr Kelly's article published in the ESRI summer bulletin, it is regrettable that his analysis was not given more consideration within the Department or indeed elsewhere. In relation to his analysis, I note that the ESRI bulletin which published his article continued to assess that the so-called "soft landing" scenario in terms of the future trajectory of housing output was at that time the most likely scenario. Furthermore, this scenario of a gradual easing back to sustainable levels of 50,000 units per annum remained the ESRI's central scenario for another 12 months and was reiterated in the May 2008 ESRI Medium Term Review. Furthermore, during this period the fiscal forecasts of the Department in relation to Stamp Duties and other property related taxes, while ultimately incorrect, were more conservative than other forecasters at the time[7].

R5b - Appropriate of advice from Department of Finance to Government

Q. 21 One of the most serious macro economic flaws identified by Regling-Watson was the over exposure of Banks to commercial property, including land and development sites. Was the Department aware of the risks, and what steps, if any, had been taken to address these issues?

Q. 22 How robustly was the Minister challenged on the tax and spending policies implemented in the 2000's? What contingency plans were put in place by the Department to deal with the problems which were envisaged?

Response

As I have stated elsewhere, the focus of the economic and budgetary side of the Department was on the macro economic and fiscal matters. As such there was not an emphasis placed on the micro or sectoral issues such as the over exposure of the banks to commercial property. The Department would not have had the level of detail or information available to it during this time to conduct in-depth analysis on the exposure of the banks to commercial property. I also note that during the years before the crisis the Central Bank did not, in my view, give sufficient weight and emphasis to the risk from the sector in its reports. Likewise, the Department mentioned risks to its forecasts and to economic growth but as noted in the Wright Report these risks while stated were not escalated accordingly. The emphasis from economic commentators was on the impacts on competitiveness - the crowding out impact of the growing dominance of the construction sector and its impact on the labour market as well as on inflation through rising property prices – and not on the financial stability of the banks until it was too late.

[7] See document titled "Input into Opening statement for PAC – 30 April 2009" and supplementary material related to the oral response of a parliamentary question on 13th May 2009. Both of these documents are attached to my statement.

Another focus of concern, which grew in the mid to late 2000's, was the significant share in tax revenue that the property sector was making. However, while the Department did warn of the risks from an over reliance on property - see various Tax Strategy Group papers (Refs: DOF02803, DOF02804, DOF02808, DOF02805, DOF02806, DOF02807), Budget Memos and other internal notes which I understand have already been supplied to the Joint Committee - risks from the commercial sector and the negative impact on the balance sheets of the commercial banks were not highlighted to, or by the Department.

As I already acknowledged, the Wright Report noted that the warnings from the Department were not adequately escalated. However, during the financial and economic crisis, I believe that robust policy advice was offered and followed, by way of evidence, I would point to the decisive and early steps that were taken in the 2008/2009 period to address as quickly as possible the emerging deterioration in the fiscal position. The advice of the Budget and Economic Division was that the downturn was predominately structural in nature and thus would not be improved if and when the economic cycle turned. The Department's call for corrective budgetary action in July 2008 and the subsequent accelerated budgetary process that autumn are examples of a so-called "contrarian view" as many other commentators felt that the downturn was cyclical and temporary as opposed to it being structural and of a permanent nature thus requiring policy action. Through a process of assertively making its case from the onset of the economic downturn by advocating the pursuit of policies that would reign in the deficit and support a return to medium term growth, the Department's policy advice ultimately formed the basis for our subsequent successful exit from the EU/IMF external support programme[8].

Finally, by way of contingency, I would point out that the Department in its Long-term issues report (sent to the Committee ref: DOF05689), published in 1998, recommended to Government, *inter alia*, for the establishment of the National Pensions Reserve Fund (NPRF) and for the commitment to assign an annual contribution of 1% of the Budget day GNP forecast ensured that Ireland had a financial buffer. This buffer formed the basis of a significant national contribution into the overall EU/IMF programme of support. It is important to note that as such this meant that Ireland had a stronger negotiation position than it might have otherwise have had, if the NPRF had not existed.

[8] I highlight the publication of the National Recovery Plan - a document that was produced by the Department, approved and subsequently published by the Government – as one of the key documents that set out our economic and fiscal policy advice which formed the backbone of the macro-fiscal piece of the EU/IMF programme.

R6a - Adequacy and impact of international organization's oversight on banking regulation and supervision activity

Q. 23 Can you describe interaction and in particular the provision of information from the Department of Finance to institutions like IMF and OECD in the running up to publication of IMF or OECD reports on Ireland?

Q. 24 Do you judge the IMF country reports and OECD reports as an important information instrument to aid in banking regulation, banking supervision and financial stability issues?
If yes, why, if not, why not?

Response

In terms of interactions with international bodies compiling reports or other such bodies writing country reports, there is always a degree of consultation between the international institution and the country under examination. In this context I, and my Division, on behalf of the Department would have engaged with international bodies on a regular basis. In my view, while there were often robust and challenging discussions, I do not believe that Ireland was afforded any special treatment.

In the case of the OECD, based on my experience, the process of engagement is as follows:

- OECD staff select the issues that they wished to consider as "Special Topics" in the forthcoming country report
- A fact finding mission would then be conducted to the country and OECD staff would usually meet with various stakeholders. This mission, generally known as the "Technical Visit", had open access to all public and private sector individuals that the OECD Staff sought to engage with while on its mission.
- Some months later the OECD staff would return to discuss their initial policy findings as well as verify and update key facts. This visit is generally known as the "Policy Mission".
- Then OECD staff would draft their report and circulate to all members of the OECD with the scope for comment to be provided. It is expected that the country under examination would supply detailed written comments on the document, explaining policies, amending factual errors and offering suggested policy amendments.
- The relevant OECD Committee - EDRC - made up of all OECD members would then meet to assess the report and to systematically question the relevant country's officials at a day long intensive meeting. During my time as the Irish Head of that day long engagement, I found the Committee to be very active with most country delegates getting involved in the debate and posing various detailed and technical questions to both OECD staff and the Irish team.
- After the Committee meeting, taking account of the findings and views of the Committee, the OECD staff and the relevant member country would then engage in a drafting session. However, the decision to accept or refuse any proposed changes to the report rest, in the first instance with the OECD staff, and ultimately with the Chair and the EDRC which signs off on the report. The report is firmly a product of the OECD and reflects the analysis and views of the staff and the membership.

A similar, but less iterative process is conducted in relation to IMF Article IV reports. The IMF staff visit the country and have open access to both public and private sector individuals on their fact find and policy reviews. The views of the Authorities are recorded within the Staff report as appropriate and clearly labelled as the "Authorities views". Then the report is presented to the IMF Board for approval and subsequent publication subject to the agreement of the country in question.

In both cases the reports and their contents are clearly the product of the institution in question and while there is a consultative process the report is very clearly seen as an external body of work offering objective policy advice to Ireland. In my experience as Assistant Secretary, the process in the Irish case with both of these institutions did not work differently than it does in other countries.

I am sure that those that re-visit the various reports drafted at the time will now with the benefit of hindsight, be able to point to warnings made. However, in my view in terms of the focus of OECD and IMF reports, prior to the financial market crisis, the negative feedback loops and spillovers from the financial sector were not well understood globally and most of the policy advice tended to be focused on the macroeconomic and budgetary areas of public policy. Like others, I would concur that in this regard the general economics profession failed.

In particular, to the best of my knowledge, until the recent international financial market crisis, the OECD tended not to get into too much financial market detail in relation to its policy recommendations contained within its country surveys. Instead, its comparative advantage was seen as offering policy advice in the macro economic and budgetary areas as well as stressing the benefits of structural reforms and labour market policy advice. The IMF periodically reviews its member countries financial sectors in what are known as FSAP Reports. In Ireland's case the last FSAP review was conducted in 2006. I had no involvement in the 2006 FSAP report.

Finally, country reports from international institutions such as the OECD and IMF are invaluable sources of external policy guidance to any country on a range of macroeconomic, fiscal and financial policies. Generally speaking such reports bring a viewpoint that may not be readily available within the country and the advice offered is generally offered based on years of cross country experiences and evidence. Thus it can be expected that the policy analysis offered will generally be thorough, insightful and offer "best practice" advice. It is important that this dispassionate and external advice, often of a broad nature, is considered carefully in the context of the specific circumstances of the country in question so as to ensure that the best policy outcomes are arrived at for the local situation. While such reports are in my view, designed to enhance domestic policy making in a collegiate manner, publication of such reports is important as this can bring an element of pressure for policy change.

3rd August, 2015