DÁIL ÉIREANN

AN COMHCHOISTE UM AIRGEADAS, CAITEACHAS POIBLÍ AND ATHCHÓIRIÚ

JOINT COMMITTEE ON FINANCE, PUBLIC EXPENDITURE AND REFORM

Déardaoin, 5 Nollaig 2013

Thursday, 5 December 2013

The Joint Committee met at 2 p.m.

MEMBERS PRESENT:

Deputy Richard Boyd Barrett,	Senator Sean D. Barrett,
Deputy Michael Creed,	Senator Thomas Byrne,
Deputy Regina Doherty,	Senator Aideen Hayden.
Deputy Timmy Dooley,	
Deputy Andrew Doyle,*	
Deputy Sean Fleming,	
Deputy Kevin Humphreys,	
Deputy Mary Lou McDonald,	
Deputy Dara Murphy,	
Deputy Kieran O'Donnell,	

* In the absence of Deputy Simon Harris.

In attendance: Deputy Lucinda Creighton.

DEPUTY DARA MURPHY IN THE CHAIR.

Business of Joint Committee

Clerk to the Committee: As there is a quorum, the meeting will commence. As both the Chairman and Vice Chairman are unavoidably absent, the committee, in accordance with Standing Order 90, must proceed at once to elect one of its members present to perform the duties devolved upon and exercise the authority conferred upon the Chairman by Standing Orders for the duration of the absence. May I have a proposal for election please?

Deputy Sean Fleming: I propose Deputy Dara Murphy.

Clerk to the Committee: Is that agreed? Agreed.

Acting Chairman (Deputy Dara Murphy): Thank you. We will commence in private session.

The joint committee went into private session at 2.05 p.m. and resumed in public session at 2.15 p.m.

Fiscal Assessment Report November 2013: Discussion with Irish Fiscal Advisory Council

Acting Chairman (Deputy Dara Murphy): I welcome the Irish Fiscal Advisory Council members to our meeting, Professor John McHale, chairman, and Professor Alan Barrett, Mr. Sebastian Barnes, Dr. Donal Donovan and Dr. Róisín O'Sullivan, council members. I also welcome Mr. Diarmaid Smyth, chief economist, Mr. John Howlin and Ms Rachel Joyce. We will begin with opening remarks by Professor McHale and committee members will then address questions to him. We will try to keep questions as concise as possible so as to allow as many questions as possible. I remind witnesses, members and those in the public Gallery to turn off their mobile phones.

I advise witnesses that by virtue of section 17(2)(*l*) of the Defamation Act 2009, witnesses are protected by absolute privilege in respect of their evidence to the committee. However, if they are directed by it to cease giving evidence on a particular matter and continue to so do, they are entitled thereafter only to qualified privilege in respect of their evidence. They are directed that only evidence connected with the subject matter of these proceedings is to be given and asked to respect the parliamentary practice to the effect that, where possible, they should not criticise or make charges against a person or an entity by name or in such a way as to make him, her or it identifiable. Members are reminded of the long-standing parliamentary practice to the effect that they should not comment on, criticise or make charges against a person outside the Houses or an official by name or in such a way as to make him or her identifiable.

I now invite Professor McHale to make his opening remarks.

Professor John McHale: It is a pleasure to be here. On behalf of the Irish Fiscal Advisory Council, I thank the committee for providing us with this opportunity to discuss our most recent assessment. The council views interactions with this committee as integral to its work and considers they have proven to be extremely valuable. Other members in attendance with me today are Mr. Sebastian Barnes, Professor Alan Barrett, Dr. Donal Donovan and Dr. Róisín O'Sullivan. The council secretariat is also present: Ms Rachel Joyce, Mr John Howlin and Mr Diarmaid Smyth, head of the secretariat and chief economist.

Today, I will cover our fifth assessment report, which was published on 22 November. The report is written in line with the mandate of the council set out in the Fiscal Responsibility Acts 2012 and 2013 and also with the memorandum of understanding between the council and the Department of Finance. The main purpose of the report is to assess the macroeconomic and budgetary projections set out by the Government in budget 2014, including the appropriateness of the overall fiscal stance. It also considers compliance with the budgetary rule set out in the Fiscal Responsibility Act. Moreover, the report sets out the process involved in the council's endorsement of the macroeconomic forecasts underpinning budget 2014. This is a new function with which the council has been tasked since our last appearance before the committee. Given its importance to the reformed budgetary process, I am keen to take this opportunity to expand on it a little. Arising from new EU requirements, the council was asked to independently scrutinise and endorse, if appropriate, the macroeconomic projections underpinning budgets and stability programme updates. This is a significant change in Ireland's budgetary architecture and should help to improve the accuracy and transparency of official forecasts. The council has developed forecasting methods and analytical capacity to support this function.

The council's endorsement is based on whether the forecasts are within an endorsable appropriate range, taking into account the methodology and the plausibility of the judgments involved. The range reflects the high degree of uncertainty surrounding economic forecasting and is informed by the council's work on gauging the historical level of macroeconomic uncertainty. As part of the endorsement exercise, the council expressed a significant reservation about one element of the macroeconomic forecasts prepared for budget 2014. The reservation related to the implied quarterly profile for consumption spending. However, following clarifications by the Department of Finance of the assumptions relating to data revisions, the council's assessment was that the forecasts were within its endorsable range.

It is important to make a distinction between the macroeconomic forecasts endorsed by the council on which budget 2014 is based and the post-budget macroeconomic forecasts. The latter take into account the impact on the economy of subsequent decisions taken as part of the budget process, including any changes to the planned aggregate consolidation, and are not endorsed by the council. The mandated role of the council in this instance is to provide an independent assessment of these final forecasts in the subsequent fiscal assessment report.

On a post-budget basis, the Department of Finance is projecting real GDP growth of 0.2% in 2013, rising to 2% in 2014. Growth this year is being depressed by several factors, including a background of ongoing balance sheet repair, budgetary consolidation and weak demand in Ireland's main trading partners. The pharmaceutical patent cliff is reducing the growth of net exports as well. While there is evidence of improving growth momentum in the second half of this year, which should carry over to next year, uncertainties relating to these elements mean that the risks to the forecasts are tilted to the downside for 2014.

Good progress continues to be made on the fiscal position and in bringing sustainability to the public finances and restoring the borrowing capacity of the State. In budget 2014 the general Government debt-to-GDP ratio is projected to peak at 124.1% this year before declining by approximately ten percentage points over the period to 2016. The general Government deficit is forecast to be below the excessive deficit procedure, EDP, ceilings for 2013 and 2014 and at the deficit ceiling for 2015. These budgetary projections are assessed to be appropriate but are contingent on the delivery of significant expenditure savings and achieving the projected acceleration in economic growth. Additional risks stem from contingent liabilities associated mainly with the banking sector. The decision to reduce the planned fiscal adjustment in budget 2014 has eliminated the previously existing margin of safety relative to the key Stability and Growth Pact deficit ceiling for 2015 of below 3% of GDP. An analysis based on historical growth forecast errors suggests that the probability of breaching the 3% ceiling has risen from an estimated one in three in our previous report to an estimated one in two, assuming there are no changes to planned adjustments for budget 2015.

The setting of fiscal policy during the crisis has required a difficult balancing of the need to support domestic demand and employment, the need to restore the State's creditworthiness and the need to put the public finances on a sustainable path. While the Government faces a trade-off between demand support and creditworthiness in the short to medium term, reducing the perceived risk of default and unstable debt dynamics is critical to laying a stable foundation for longer-term growth and employment. The fiscal adjustment programme undertaken to date is working in terms of stabilising the public finances and restoring the creditworthiness of the State. Market perceptions of sovereign default risk have fallen sharply. Simulations indicate that in the absence of fiscal adjustment from 2008 to 2013, this year's deficit would have been close to 20% of GDP, with the debt ratio close to 106% of GDP and rising.

The Government's planned fiscal stance for 2014 and 2015 is assessed to be conducive to prudent economic and budgetary management. However, the council remains of the view that the most appropriate policy for budget 2014 was to continue with the previously planned adjustment of €3.1 billion rather than the reduced amount of €2.5 billion. This higher adjustment would have created a greater margin of safety in meeting the EDP deficit targets in a highly uncertain growth environment and would have reinforced credibility gains from successfully delivering on previously announced adjustment plans.

There should be no reduction in the Government's previously announced adjustments of €2 billion for 2015. Additional adjustments may be required to ensure the target is achieved if growth projections are reduced or other contingencies raise the projected deficit for 2015. Any future upward revision in growth projections should be used to reinforce credibility by providing a margin of safety to ensure the EDP deficit target of 2.9% is complied with in 2015.

Projections extended to the end of the decade indicate that the most difficult phase of the adjustment, which has involved large nominal expenditure and revenue changes, should be broadly complete by 2015 or 2016. Modest increases in nominal expenditure should be feasible post-2016 while meeting all domestic and European fiscal rules. However, the extent of the tightness of the fiscal stance should not be underestimated, as the scope for real expenditure increases will be limited. Significant risks also surround this scenario given the length of the projection horizon.

Given the fragile international financial environment, the council would have supported an application for a precautionary credit line. Provided it had come with reasonable terms and conditions, such a facility would have provided valuable additional protection against any renewed funding pressures as Ireland moved to exit the EU-IMF programme.

I thank the committee for providing us with the opportunity to attend today. We look forward to taking the committee's questions and hearing the views of members.

Acting Chairman (Deputy Dara Murphy): I have some brief questions to kick off the discussion before I bring in my colleagues. This is the first time the council has engaged in the endorsement process. I note from the timelines that there was some engagement between the council and the Department about the consumption estimates. Given that this is the first time, does the council have any suggestions or proposals to further develop the relationship between the council and the Department in the process running up to the budget? In particular, can the council indicate what and how the clarification was arrived at which allowed it to endorse the consumption figures and other figures? Professor McHale referred to the endorsable range, which has come up with respect to many elements, especially the €2.5 billion and €3.1 billion adjustment proposals. Has the council done any modelling on the endorsable range? Is it a proportion or a percentage? Is there a colouring within the range? Can the council give us some clarification on that?

Will the council comment on some of the indicators that we have seen recently and the impact they may have in 2014, especially the strong growth in employment and how it may affect demand as well as the forecast growth of 2% for 2014? What about house prices? There has been some commentary to the effect that the strengthening of house prices may positively affect some of the contingent liability concerns with respect to the banks. What is Professor McHale's view?

Professor John McHale: These are important questions. I will comment briefly on each of them and then allow my colleagues on the council to comment as well. The Acting Chairman is perfectly correct to say that we had one significant reservation in the endorsement process relating to the consumption profile. Essentially, the consumption growth that would have been required to take place over the second half of the year looked implausibly high to achieve the forecast for annual consumption growth for 2013, unless one anticipated revisions to the consumption numbers for the first half of the year.

We really had a problem with the internal consistency of the forecasts because initially we asked the Department of Finance what it assumed about the revisions. It was taking them at face value, assuming that there was no bias in either direction. That was not consistent with the annual forecast, which would have required annualised growth in consumption of close to 8% over the second half of the year. Discussion with the Department of Finance made it clear that, because of recent indicators showing that the economy was stronger than it had appeared to be in the first half of the year, it was allowing for a likelihood that there would be upward revisions to the first half of the year. The agreement was that it would state that possibility explicitly and relate it to the more positive high-frequency indicators as a basis for anticipating the likelihood of that upward revision, although there was no certainty about that. This allowed us at least to see the forecast that we had been given as being internally consistent. We felt that particular reservation had been dealt with and that we were in a position to endorse it. We had set out a detailed memorandum of understanding in advance that was closely followed, so the process ran very smoothly. We are considering minor revisions to the memorandum of understanding, which mainly involve extending it for the next endorsement round, for the stability programme update. On the whole the process worked well.

In response to the question about the endorsable range, several inputs are involved, a key one of which is to examine historical forecast errors, because there will always be significant uncertainty around macroeconomic forecasts. To gauge what is an acceptable range for forecasts, it is important to examine those historical forecast errors. We do not treat those mechanically. We also use judgment. We discussed at length whether we should publish our endorsable ranges, but because there is an element of judgment we did not want to make clear the range we would endorse because we did not want to create an incentive for a Department to push to the limits of that range in the future, although we certainly do not believe that applies at present. We use an endorsable range and we make several inputs into that, but we think it is better not to state it publicly.

The recent indicators certainly have been very positive, particularly on the employment front. The quarterly national household survey showed very strong employment growth year-on-year between the third quarter of last year and the third quarter of this year, with total employment up by 58,000, which is very encouraging. The recent live register numbers show that strong momentum in the labour market seems to have continued into the fourth quarter, with the unemployment rate dropping to a seasonally adjusted 12.5%. We have certainly seen strong growth momentum in the second half of this year. The improvement in growth for 2014 is largely based on the continuation of that momentum. The Department of Finance projection for growth next year is 2%. The even stronger than anticipated employment numbers, which seem to be supported by the recent Exchequer returns, which were particularly strong in November both for income tax and VAT, reinforces the impression that the momentum will continue, and if anything it seems to be strengthening.

House prices are another indicator. As everybody knows, house price growth has been particularly strong in the Dublin area, but there are strong signs of stabilisation and a return to house price growth nationally. From a macroeconomic perspective, that helps household balance sheets, which should help to underpin consumption growth further. It is also a positive for balance sheets in the banking sector in that it improves collateral and should make it more attractive to lend for mortgage purposes. The Deputy mentioned specifically the contingent liability in the banking sector. There are still some risks around contingent liability in the banking sector and the possible need for additional capital. Even though the most recent balance sheet assessments suggest that additional capital is not needed at least immediately, it remains something that we need to watch. However, to the extent that the housing market seems strong, it is moving in the right direction to limit the possibility of those capital needs.

Professor Alan Barrett: When the Acting Chairman asked the question about the endorsable range he also mentioned the figures of €3.1 billion and €2.5 billion. It might be handy to clarify what we were endorsing, because another member of this committee, Deputy Spring, seems to have been confused on this point. We only endorsed the macroeconomic forecasts underpinning the budget. The question of €3.1 billion or €2.5 billion was not part of our endorsement exercise. It had a mechanical impact on the final set of forecasts because the fact that there was a lower overall consolidation meant that the numbers were a little bit different. It is important to state precisely what it was we were endorsing and what we were not endorsing.

Acting Chairman (Deputy Dara Murphy): I think there was a comment on "Prime Time" and the response was that it would be within the endorsable range.

Professor Alan Barrett: The only things within the endorsable range were the macro-economic forecasts. When it came to the question of €3.1 billion versus €2.5 billion, we held to the view that the adjustment should have been €3.1 billion.

Mr. Sebastian Barnes: To make it more confusing, we are economists and we recognise uncertainty, so we love ranges. We have several ranges and I think that is one of the things that makes it complicated. When we look at the forecast for endorsement, we recognise that there are many sets of numbers that could be okay and that is our endorsable range for the forecast. In a separate exercise, when we talk about assessing the fiscal stance we also have a range because we think it is possible to set the fiscal policy in different ways. That also would be okay. We have these two ranges which fit into quite different parts of our mandate and they are about different things. If anyone knows a synonym for the word "range" they should perhaps get in touch with the Fiscal Council.

Acting Chairman (Deputy Dara Murphy): It will not be too long before the ranges have to be published, but the witnesses have a view on that at the moment. I call Deputy Sean Fleming.

Deputy Sean Fleming: The witnesses are very welcome here today and I thank them for their brief presentation. They are very clear that the Government should have continued with the previously planned adjustment of €3.1 billion rather than the reduced amount of €2.5 billion, but the Minister's statement consistently refers to the €3.1 billion adjustment made up of expenditure reductions, taxation measures amounting to €2.5 billion and other measures. The Minister believes his budget adjustment was €3.1 billion but Professor McHale is saying it was €2.5 billion. We will not debate the difference. Which figure is accepted by Europe? Let us forget the message for local consumption. Which is the real figure that people outside Ireland accept as the adjustment?

Professor John McHale: I do not wish to speak for the European Commission but the standard measure of adjustment includes new consolidation measures such as new tax and expenditure measures. Certainly the additional €600 million affected the projection for the deficit for 2014 so it included revision to the Central Bank income, a revision to estimates for interest costs. They are deficit-affecting. If one wishes to define "adjustment" as adjustments to the projection for deficit, it could need that definition of adjustment. Historically it has been very clear to us what the adjustment figure in the budget, the figures which we are familiar with over the past few years, means these new tax and expenditure measures which amounted to €2.5 billion.

Deputy Sean Fleming: I understand that. Professor McHale believes that next year the Government should hold to the target of €2 billion. Given that this year the Government was able to find €600 million to meet its target of €3.1 billion - which it says has been met - and many were once-off measures - surely next year, the Government will be able to produce once-off measures amounting to €1 billion. The Government has made clear that when it receives the dividend of €400 million from the ESB will be of its choosing. The timing in respect of the receipt of the lottery licence, which is a fee of €200 million, will also be of its choosing. This can be used as a once-off measure for the budget next year or the following year. Is it correct that once-off measures should be used in these situations to achieve the budget deficit target?

Professor John McHale: It certainly should not be called consolidation measures.

Deputy Sean Fleming: The Minister did not do so. In his budget speech he talked about the overall adjustment of €3.1 billion, made up of €2.5 billion taxation and expenditure measures plus €600 million on other items.

Professor John McHale: I can only speak for what the Irish Fiscal Advisory Council plans to do. It has a clear view of what constitutes consolidation measures.

Deputy Sean Fleming: In view of what has happened this year with regard to the €600 million, is it an issue that the council would address in advance of the budget next year when giving its endorsement? The council has been forewarned that €600 million, €800 million, €1 billion, can be produced from somewhere else other than consolidation measures to which Professor McHale referred.

Professor John McHale: We addressed it in the most recent fiscal assessment report. Mr.

Barnes may have the particular wording to hand. We called for the budget documentation to make very clear the distinction between the consolidation measures and other deficit-affecting changes.

Deputy Sean Fleming: Professor McHale has read the budget document and he will know that it contained no breakdown of that €600 million. In retrospect it should have made clear where the €600 million was.

Professor John McHale: Yes. We have called for that.

Deputy Sean Fleming: In future if there are to be on-off other items this should be made clear in the documentation presented to the Oireachtas on budget day. It took parliamentary questions over the following ten days to even elucidate these matters.

Would it assist the long-term well-being of our banks if the Central Bank were to publish its detailed assessment of the banks' assets quality? Is there room for tax cuts in the next year or two? The Government receives the views of the fiscal advisory council into account but I do not think it ever fully implements the council's final recommendations. Is it the norm in other EU countries that the advice of a fiscal council is noted but not implemented?

Professor John McHale: I thank the Deputy for those questions. His question about the Central Bank is a question for the Central Bank itself to answer. The ECB will carry out a comprehensive assessment. Therefore, releasing numbers at this point could create some confusion in that process.

Deputy Sean Fleming: Does Professor McHale think there will be a difference between the assessment carried out by our Central Bank and that of the ECB?

Professor John McHale: There could be. They will be carried out under difference assumptions and rules. The European Central Bank exercise will include a stress test. The argument for releasing the information now is countered by opposing arguments. The Central Bank is closest to that process so I would not second-guess its decision. I do not think there is room for tax cuts or expenditure increases in budget 2015. As I noted in my statement the council believes that the current plans for €2 billion in additional adjustments should be followed through. If growth comes out as anticipated, we should be okay with an effectively neutral budget in 2016 without the need for additional measures. In chapter four of our report we have looked forward in time to 2019 in order to gauge the room for expansionary measures that will ensure full compliance with all fiscal rules. We ran scenarios for doing the minimum consolidation necessary in order to achieve all the fiscal rules and to see what level of both nominal and real expansion - which could be split between tax cuts and expenditure increases - would be possible. We see limited room, post-2016. There will be greater room for nominal adjustments and less room when taking into account that there is likely to be inflation occurring over that period as a result of the real impact of those expenditure and tax changes.

To answer the Deputy's question, we really do not see scope in the next year or two but if growth projections pan out as currently anticipated, there could well be scope after 2016.

On the question about the advice given by the council, the frequent comment is that we are being ignored. However, it should be noted that we have been broadly supportive of the Government's fiscal strategy which has succeeded in stabilising the public finances and restoring the borrowing capacity of the State. The disagreements have come more on the fine tuning of fiscal policy which will include this decision of whether to do €3.1 billion or €2.5 billion. The fine tuning involves balancing acts. We can understand that the Government might make a different balancing of the factors than we did. The Government takes our analysis on board when making a decision but when it comes to those fine tuning decisions, if the Government does not follow exactly our analysis, we do not consider that this means it is ignoring our advice. There is a key phrase in the fiscal responsibility Act which states the council must assess if the Government's overall fiscal stance is conducive to prudent economic and budgetary management. In each of our reports we have found that this test was met. If we were to find that this criterion was not satisfied - that we considered the Government to be following an imprudent policy - and if our view were ignored at that point, then that would be a much more serious issue. It is important to distinguish between the levels of advice or criticism that we may give. Although we are called the Irish Fiscal Advisory Council, we also have an important watchdog role. Other key components of our mandate include the endorsement function itself and our assessment of compliance, particularly in respect of the budgetary rule set out in the Fiscal Responsibility Act. We have been able, once again, to endorse the macroeconomic forecasts in this round. In other words, we have assessed that the Government is in compliance with the budgetary rule. As I said, if we were to assess otherwise and were that finding to be ignored, there would be a much more serious issue.

Deputy Sean Fleming: Most of the debate on reducing expenditure has focused on the large spending Departments, namely, Social Protection, Health and Education and Skills. However, even though the interest on the national debt is in the order of €8 billion or €9 billion, there is never the same level of debate on that issue in the Chamber, primarily because those payments are made out of the Central Fund and are not voted through the Oireachtas.

Acting Chairman (Deputy Dara Murphy): Does the Deputy have a question?

Deputy Sean Fleming: I do. What advice might the Irish Fiscal Advisory Council give to the Government in terms of renegotiating the cost of servicing the national debt in the next year or two, after we have returned to the markets? We cannot continue to reduce voted expenditure in line Departments without any debate at all on reducing the interest payment on the national debt. Does Professor McHale believe the same level of public interest should be devoted to that topic as we are giving to health service plans, social protection expenditure and so on?

Professor John McHale: There is a very important difference between interest expenditure and health and social protection expenditure in that the latter two are decision variables for the Government while the interest on the national debt is a contractual commitment and is not open for decision at budget time. This is particularly so in the case of debts to official lenders, including the European Stability Mechanism and the IMF. Such arrangements can potentially be renegotiated, but we would not really see it as part of the mandate of the Irish Fiscal Advisory Council to advise on the negotiating stance the Government might adopt with those bodies.

Deputy Kieran O'Donnell: I welcome Professor McHale and his colleagues and thank them for the valuable work they do. The Irish Fiscal Advisory Council has adjusted its assessment of the likelihood of Ireland's breaching the 3% deficit ceiling from one in three to one in two. The November Exchequer returns released yesterday show that we are more than €500 million ahead of target in terms of taxes. The witnesses referred to various different risks and constraints they have identified in various areas. Have they had time to reflect on their report in the context of the latest data? Was the decision to amend the risk ratio a unanimous one among the members of the council? I would appreciate a general flavour of their thinking in this regard. It would be helpful to distil it down into practical terms which can be appreciated by ordinary people.

Mr. Sebastian Barnes: The Deputy has asked a very good question which has different elements. Our objective in offering that ratio is to communicate what the risks are. A choice has been made in the budget which means that the balance of risks is different from what it would have been if that choice had not been made.

Deputy Kieran O'Donnell: To what choice is Mr. Barnes referring?

Mr. Sebastian Barnes: I am referring to the adjustment in the amount of consolidation in the budget. That decision affects what the projection is, where the centre of distribution is and, by extension, what the risks are in terms of meeting a fixed target like 2.9% or 3%. The exercise we have presented is a very precise one based on historical forecast errors on the macroeconomic side. Based on that exercise and some other modelling work, we see the probability of a breach in the ceiling shifting from one in three to one in two. It is a very limited exercise and does not reflect all of the issues. That said, the exercise does feel right to us in terms of the balance of risks at this stage.

Deputy Kieran O'Donnell: It is a significant shift, from a one in three chance to a one in two, particularly in a context where we are seeing growth in employment, a reduction in the live register and stabilising public finances. Yesterday Forbes described Ireland as the best country in which to do business. In short, the indicators are good. Moreover, there is a legitimate view that, like riding a racehorse, where there is room to loosen the reins a little, the horse will go faster. I realise I am pressing Mr. Barnes on this point but I am very interested to understand the council's reasoning on this. There is reference in its documentation to pressure on the health budget, the cost implications of the IBRC liquidation and so on. Will Mr. Barnes outline the key factors behind this shift?

Mr. Sebastian Barnes: In assessing risks we must look at the forecasts, and many of the factors the Deputy mentioned are built into those forecasts. The Department of Finance's budget projections are assuming that growth will pick up, which is consistent with what Forbes is saying and the positive employment figures. In fact, the increase in employment we have seen is faster than what was indicated in the forecasts. That is the central case. To get to a particular number for the public finances, which is what this exercise is about, the probability of reaching 3% in 2015 also depends on what is assumed for the public finances. Based on what was in the budget, which featured a scaling back on the amount of consolidation, it is less likely that the target will be achieved by a significant amount. That is what we have expressed here.

There are other risks to take into account, as well as some of the positives that have been pointed out. It might be the case, for example, that Central Bank income is higher than assumed or something like that. There are margins of adjustment. On the other hand, the control of health expenditure might be worse next year than anticipated.

Deputy Kieran O'Donnell: The point I am making is that somebody looking in would surely conclude that Ireland is on an upward curve to which the markets are reacting very well. Why then did the Irish Fiscal Advisory Council come to the conclusion that the risks of breaching the deficit ceiling have increased from one in three to one in two?

Mr. Sebastian Barnes: Those statements are not inconsistent. We acknowledged in our report that a great deal of progress has been made on fiscal consolidation and we expect the economy to accelerate. These are all good things, as is the projection that the public finances will improve over the next two years. The point we are making in the report is that the public finances will now improve by less than would have been the case had the initial amount of consolidation been adhered to. We are trying to present an objective analysis. The situation is indeed improving and we hope the report accurately reflects our acceptance of that view. At the same time, however, as a result of the budget decision, the risks have increased. To clarify, we have assessed that the Government is pursuing an appropriate policy. We are not saying it is a reckless policy but simply that, in our view, the risks have increased and are greater than they would have been had this decision not been taken.

Professor John McHale: On that point, the Government's projection in the stability programme update in April was for a deficit in 2015 of 2.2% of GDP. Given that this was a central projection, the probability of missing the 3% target was relatively low at one in three. As a result of the imposition of a lesser adjustment in the budget and a worsening in terms of the level of nominal GDP and some other changes, the overall projection in the most recent budget is for a deficit in 2015 of 2.9%. Our figure of a breach probability of one in two is no mystery if one considers that the gross risks are reasonably balanced around the central forecast. There is a 50-50 chance that the deficit is going to be above it.

Deputy Kieran O'Donnell: Professor McHale would consider the glass to be half full rather than half empty.

Acting Chairman (Deputy Dara Murphy): Deputy O'Donnell is using up his time and not asking all of his allotted questions. He needs to move on.

Deputy Kieran O'Donnell: My second question relates to the precautionary credit line. In its report, the council's proposal in the context of pushing for such a credit line was qualified to some extent. International market reaction in respect of our bond yields and in general has been extremely positive. Did the council reach a unanimous decision on the proposal that we should seek a precautionary credit line? On mature reflection, does the council wish to reconsider its position?

Dr. Donal Donovan: In its previous report, the council endorsed the concept of a precautionary credit line. We all felt it was a good idea at the time. In our most recent report, we indicated that we thought it was a good idea. As stated earlier, we still think it would have been a good idea.

Deputy Kieran O'Donnell: So it was a unanimous decision.

Dr. Donal Donovan: Obviously, one cannot state *ex ante* whether insurance would be worthwhile. One way to consider this is in the context of car insurance. Just because one does not have an accident in a particular year even though one had taken out motor insurance, one would not necessarily state that it was a bad idea to take it out. We were of the view that this was a good idea, provided the terms and conditions were reasonable. I am sure the Government considered many aspects prior to making its decision. One can imagine one aspect was that at the time the Government took its decision, the position regarding what would be the terms and conditions was not entirely clear. I would imagine that the position was also unclear as to when these could be clarified and to the type of procedures to which such a credit line would be subject. The latter was largely to do with the political situation across Europe in general and in Germany in particular.

Deputy Kieran O'Donnell: We have €20 billion in reserve. Is that not a significant insurance policy? Are our guests not pleasantly and agreeably surprised by the markets' reaction to the announcement by the Government? As Klaus Regling, managing director of the ESM, indicated as recently as yesterday, the Government's decision was the right one.

Dr. Donal Donovan: The €20 billion is an important weapon in an arsenal of protection and we stress this in our report. We also indicated, however, that there is a range of actions which could be taken and that using up the money in the kitty if things were to go wrong might not necessarily be the most prudent approach.

In the context of reactions, it is fair to say that, according to reports, there were different views beforehand. Different institutions to which the Deputy referred - some of which are external - urged the Government to consider this. I am sure that the right and proper approach for such institutions - once a decision has been taken - is to wish the Government the best of luck and indicate that they will give it all the support it deserves in order to allow it to pursue its policy.

Deputy Kieran O'Donnell: Does Dr. Donovan accept that international market reaction has been positive?

Dr. Donal Donovan: There certainly has been no sign that this decision - which may have been anticipated by the market - has led to any negative reaction. That is absolutely true. To be honest, the question which could arise as we look forward into 2014 and the possibilities in respect of bank recapitalisation, uncertain growth in the euro area, etc., is that were things not to work out, the markets might become a little nervous. We are all hoping that will not happen.

Deputy Kieran O'Donnell: On the question of the recapitalisation of the banks via the ESM, is there merit in the latter dealing with the banks in the context of the tracker mortgages they hold? Would our guests regard this as a good policy initiative?

Acting Chairman (Deputy Dara Murphy): The Deputy should conclude.

Professor John McHale: Anything that would improve our debt position would be welcome. If there needed to be additional capital in the Irish banks, it would certainly be better were this to be provided by the ESM.

Deputy Kieran O'Donnell: Will Professor McHale comment specifically on trackers?

Professor John McHale: The tracker mortgages on the books of the banks are reducing their profitability and worsening the position with regard to their balance sheets. Anything that can be done in the context of providing low-cost funding for tracker mortgages would be a positive development. Is it a likely development? Essentially, that would involve a transfer from other European countries to Ireland in the form of subsidised funding. Such funding would come at a lower cost than that which we could raise ourselves. It would certainly be welcome but, I think, unlikely.

Deputy Mary Lou McDonald: I am left to wonder what is the endorsement range for the Government in respect of the advice the councils provides it. That range would seem to be pretty narrow. I wish to put five questions to our guests. I will try to get through them in the 12 minutes available.

On the advice the council gave in respect of the precautionary credit line, reference was made to levels of advice offered to the Government. Will Professor McHale indicate whether this was official advice and whether it was made in written form? I am sure that if it were written, the committee would be very interested in seeing it.

In his opening contribution Professor McHale referred to there being scope for modest increases in expenditure post-2016. Given that it is in the excessive deficit procedure, I understand that the balanced-budget rule currently does not apply to this State. However, that rule will kick in at some stage and we will be confronted with the issue of the 0.5% structural deficit. I presume the council factored this into its thinking when it arrived at its conclusion to the effect that there would be scope for modest increases in expenditure after 2016. In view of the fact that the council has assessed where matters would stand in the context of our debt had all of the austerity not happened, I am sure it has tried to estimate what that 0.5% structural deficit will mean by way of further consolidation.

Economists are like all other professionals in that their advice comes with the appropriate caveats built in. The council points out in its report how tricky it is to forecast growth. In their predictions for 2013, the Central Bank, the Department of Finance, the ESRI, the IMF, the European Commission and the OECD all forecast growth of at least 2%. We know that this did not materialise and that the actual rate will be approximately 0.2%. That is dramatically lower than predicted. Will our guests map out the consequences if the scenario in this regard were to be replayed in 2014? What impact would such an eventuality have in terms of targets, etc.?

In its assessment of budgetary forecasts, the council referenced slippage in terms of current spending and attributed this to weaker economic conditions and policy decisions. Professor McHale attributes that to weaker economic conditions and then policy decisions. Can he elaborate on the policy decisions to which he was referring? Might I speculate that it may have been related to health spending being out of control and an inability to meet budgetary targets?

Professor McHale went on to comment about public confusion on the size and composition of the budgetary adjustment. Will he elaborate on that statement also? He further stated that the Government should “identify more clearly the impacts of consolidation measures”. That is fair enough but I would like to know the type of analysis he has in mind. Is it a purely fiscal analysis or a broader impact assessment of different sectors of society, say, women or people with disabilities? That is an issue we have raised with both the Minister for Finance and the Minister for Public Expenditure and Reform with an eye to further improving the budgetary architecture and decision-making by embedding equality budgeting and assessments in real time on real cohorts of people and not just a purely mathematical analysis in the broadest sense. Those are my questions which I have raced through somewhat but I ask Professor McHale to work his way through them.

Acting Chairman (Deputy Dara Murphy): The Deputy has asked all her questions, which is helpful. Professor McHale has seven or eight minutes to answer them. I will indicate when he has about one minute remaining.

Professor John McHale: I will try to be brief as my colleagues will want to speak again. On the precautionary credit line, we do not give any advice in private. All our advice is public advice and the main way we give that advice is through the assessment reports and through our appearances before the members of this committee. We make ourselves available to the media also. This report came out after the decision about the precautionary line was made but as Dr. Donal Donovan said, we had set out that advice in our previous fiscal assessment report, which was published in April. That advice has been available for a while and we made sure to amplify that advice through the media, letting the public and also the Government know our thinking on that. We do not advise the Government privately. We have not been set up that way.

Deputy Mary Lou McDonald: The fiscal advisory council did not have any private conversations or consultations with the Minister for Finance.

Professor John McHale: We interact with officials from the Department of Finance but it is more on technical matters getting data. It is not giving them advice.

Deputy Mary Lou McDonald: It is at official rather than ministerial level.

Professor John McHale: It is at official level. I should say that early on in the council we had one meet and greet dinner with the Minister for Finance but we did not discuss policy; he just wanted to say "Thank you". There has been no other contacts with the Minister.

Regarding the Deputy's second question on what happens post-2015 into 2016, I previously indicated that the need for further adjustment measures should be over if the growth projections come to pass after 2015. The good news is that even when we do not do anything in terms of additional measures, nominal GDP growth will bring about improvement in the structural balance. The reason the requirements under the adjustment path condition, which as the Deputy said is to improve the underlying structural deficit by 0.5% per year, can be met without additional measures is because of the assumption of nominal GDP growth. It is a case of working through the tax system. If we do not make any changes to the tax system in terms of the tax bands, just having nominal GDP growth and also having more people working and earning incomes will generate more tax revenues and-----

Deputy Mary Lou McDonald: For the purposes of clarity, the fiscal assessment report states:

> Extended projections out to the end of the decade indicate that the most difficult phase of the adjustment [cutbacks] should be broadly complete in 2015/2016. Modest increases in nominal expenditure should be feasible post-2016, while meeting all domestic and European fiscal rules.

The council, as a body, is satisfied that that is the likely scenario taking account of the new rules in the fiscal treaty and so on.

Professor John McHale: Yes.

Deputy Mary Lou McDonald: Professor McHale is happy to put that on the record at this point.

Professor John McHale: Under the central growth forecasts, about which there is huge uncertainty, if the Deputy has the report in front of her-----

Deputy Mary Lou McDonald: I do.

Professor John McHale: -----I ask her to turn to page 85, panel f, which shows the adjustments to date. Here we were assuming a €3.1 billion adjustment for this budget because this was based on data in the SPU. She will see the planned adjustment of €2 billion in 2015. She will see also that the numbers turn negative from that point in terms of the overall nominal adjustment that needs to take place in the budget, aside from the horrible fake positive figures that we have been living with in recent years. It is calculated to identify the minimum adjustment, which can turn negative, that is consistent with meeting all the fiscal rules, including the adjustment path rule the Deputy mentioned. If she wants to get a sense of how the other fiscal variables, including the structural budget balance, evolve under these scenarios she can see that in the other panels in the table.

On the next page we show what it would look like if we had to do a 0.75% improvement in the structural balance each year rather than a 0.50% improvement. That is to get a sense of the sensitivity of these projections to the policy target in terms of improving the structural budget balance. There is important good news here-----

Deputy Mary Lou McDonald: For the lay person that is an interesting and sophisticated analysis, and I have no doubt it is very valuable, but Professor McHale cannot say that modest increases in nominal expenditure should be feasible post-2016 because as he has elucidated in his report, there are far too many uncertainties and variables. Would that be a fair comment?

Professor John McHale: If the growth figures come in less than forecast, that picture would worsen. If the growth figures come in better than forecast, and Deputy O'Donnell mentioned some recent positive momentum, that would lead us to perhaps be a little more optimistic, then-----

Deputy Mary Lou McDonald: It is all down to the growth figures.

Professor John McHale: It is all down to the growth figures. That is a very important point but it is an important message to send out because sometimes there is a sense that because of these fiscal rules we face endless austerity. While as the Deputy rightly underlined that there is no guarantee in that regard because it depends on growth, under the central growth forecasts we should be through the worst of it after 2015.

Deputy Mary Lou McDonald: Professor McHale might now refer to growth and the scenario I put to him-----

Professor John McHale: It certainly leads into that.

Deputy Mary Lou McDonald: Is Professor McHale saying that essentially we are reliant on GDP growth to sort out the 0.5% structural target?

Professor John McHale: It plays a very significant role. The key is that it is nominal GDP growth as opposed to real GDP growth.

Mr. Sebastian Barnes: If I may clarify something that is very relevant in the current context, obviously in an Irish context it is not GDP; it is also the tax base, which is not quite the same. One of the very significant developments is the pharmaceutical patent cliff, which will drag on GDP but will not drag on the tax base as much. We will go through a position where the GDP numbers might not look great because of what is happening in a specific sector but the underlying economy and what is driving taxes is doing better. It is a time when we have to be particularly cautious about interpreting GDP but obviously the basic principle is the same.

Deputy Mary Lou McDonald: As we have one minute left Professor McHale might continue on the question of growth.

Professor John McHale: Growth is a very important question, following up on the caution. In a sense there are two conflicting things happening. On the one hand, as Deputy O'Donnell stated, there is encouraging, positive momentum. We all welcome what is happening on the employment front in particular but on the other side, and what leads to caution and the reason we believe the risks are tilted to the down side, at least for 2014, is that we know from history that the kind of recession we are going through can be very persistent. The Deputy is right that there has been a sequence of downward revisions to growth as the recession has proved more persistent than was initially forecast. While the recent indicators are very positive, we cannot forget about the type of balance sheet recession we are going through. We certainly cannot rule out that there could be negative surprises. Those two things are battling at the moment and, hopefully, the things leading to stronger growth will win out. They appear to be but because we have had a series of years of downward revisions and because of what we have seen happen in other countries that have gone through these types of recessions, starting with Japan, the Scandinavian countries and a number of others, we still have to be quite cautious at this point. That is the reason we talk a good deal about risk and we think it is important to have these margins of safety in place. This relates to a previous question from Deputy O'Donnell and to Deputy McDonald's earlier question, and while there no guarantees about that risk-----

Deputy Mary Lou McDonald: On a scale of one to ten, how confident is Professor McHale about a growth projection of 2% for 2014?

Acting Chairman (Deputy Dara Murphy): There can be only one answer of one figure when Professor McHale is answering that question.

Deputy Mary Lou McDonald: On a scale of one to ten, that is the range within which Professor McHale can indicate his endorsement in terms of a growth projection.

Professor John McHale: We lay this out very clearly. We think it is the most likely number but the risks-----

Deputy Mary Lou McDonald: Is that a five?

Deputy Richard Boyd Barrett: As I have said to the delegates previously, I enjoy these engagements with them because they are always interesting, even if I do not always agree with their outlook. To summarise, Professor McHale seems to be saying that things are more or less on target and that we should be able to begin to reduce the debt and should be over the worst of the big adjustments, the austerity budgets and so on but whether we are or not depends on growth and our forecasts in terms of growth are very unreliable and the risks of whether that growth will materialise are on the down side, to use his interesting terminology. In other words, he is not terribly confident that we will achieve the growth that will be necessary for everything to work out fine, as we are being encouraged to believe we will. That is not something that would inspire huge confidence. It is that a fair assessment of what Professor McHale is saying? Is it something that should give us confidence because it certainly does not give me confidence, particularly given the unreliability of previous growth forecasts and the failure of real growth to match the forecasts.

Professor John McHale: The Deputy's assessment up to the last thing he said was a very good summary of our position but he said we are not terribly confident. I think we are reasonably confident in the growth forecasts and that is why we have endorsed them but there are risks and we have used the phrase "tilted to the down side". It is very important to think about what can go wrong and to try to protect oneself as well as one can. The point here is what actions we can take now to protect the country in the future. Dr. Donovan talked about the precautionary credit line and that would be one layer of protection. We have also talked about having some margin of safety in regard to those key deficit targets because much of the improvement in the creditworthiness of the State and the return of our borrowing capacity has been achieved because we have met those key targets and there is a good deal of focus particularly on that 3% deficit target for 2015. Another way to protect ourselves in this uncertain world is to have that margin of safety in place. We are reasonably confident about the forecasts but we want to highlight the risks and to encourage actions to protect the country against those risks.

Dr. Donal Donovan: I would like to add one comment in response to the Deputy's question. There is always a problem macroeconomic forecasters have when trying to assess a turning point. When one is in a recession and especially a balance sheet recession, an awful lot depends on the return of confidence. It is not possible to predict with any degree of confidence, no matter how great a statistician one is, when the turning point will come. If we consider what has happened historically, typically, a turning point comes but it may not be six months from now, it may be a little later, who knows, but when it does turn around, typically, the turnaround then proceeds at a faster rate than people had expected it would. We have had this perennial problem through the decades of not knowing the timing and underestimating the extent of the turning point.

Deputy Richard Boyd Barrett: I want to dig into the risks and also the dynamics of possible recovery which is also important. On the downside risks, is it fair to say that many of the risks emanate from what could happen in the wider European and international economy? If that is the case, and I believe that is the reason there is so much uncertainty because it is so unstable, does Professor McHale consider it is sensible that State policy and Government policy seem to be so focused on opening us even more to the vagaries of the global market and foreign direct investment, and we hear constant references to the fact that we are a small open economy and that is our future? Is that not opening us up more to the risks when, if what we need is insulation against the risks, we should be trying to shore up our economy to be able to better weather a situation where the downside risks materialise? To give an example of that, and I would be interested to hear Professor McHale's comment on this, property prices are beginning rise, perhaps somewhat surprisingly at present, and some of us are concerned that a property bubble is beginning to develop again. I note alarmingly that we have a property-based tax incentive, called real estimate investment trusts, which is technocratic language for enabling big corporate property investors to invest in the bottomed out property in the Irish economy and essentially speculate on making money out of it. That is driving up rents, which is causing a housing crisis, and showing alarming signs of a possible return to another property bubble. Is the advisory council not worried about that and is it not its responsibility to be worried about a possible return to a property bubble?

Professor John McHale: First, to respond to the Deputy's question about downside risks, he is right that our exposure to the global economy is one key source of risk but I would not downplay the domestic risks as well because the dynamics of the balance sheet recession that we are talking about is much more of a domestic story than an international one, but the Deputy is right that our exposure to the international economy makes us very sensitive to what is happening in the global economy. If we were to close ourselves off, it would reduce volatility but it probably would also substantially reduce average growth rates. The successful phases of Irish growth have been the adoption of outward orientated policies starting in 1950s and the good phase of recent Irish growth in the 1990s was again very much due to the success of the export part of the economy. We could insulate ourselves by closing ourselves off but it would probably come with a large price in terms of growth.

In terms of a property bubble, the Deputy is right in saying that it something on which we need to be very focused. Where the fiscal council probably would have most importance is when times are good, not when times are bad. There are many restraints on Government-----

Deputy Richard Boyd Barrett: Or when times are good for some and not so good for others.

Professor John McHale: If the Deputy thinks back to the last bubble phase, if a fiscal council had been in place then it should have been shouting "stop" and I hope that if we had been in place then we would have done so. We are very alert to bubbles, particularly to unsustainable growth and unsustainable tax revenues that lead to an unsustainable budgetary position, but at this point we are seeing some regionally isolated price growth and it certainly has been strong price growth, seemingly reflecting shortages of supply. If the Deputy thinks back to the bubble that we went through before, there were three interacting bubbles, a credit bubble, a construction bubble as well as a price bubble, and they were all reinforcing each other. We are not seeing a credit bubble now, if anything, it is the opposite, with credit conditions being incredibly tight. We are not seeing the credit bubble. If anything, it is the opposite. We have created conditions incredibly tight. We are not seeing a strong bounce back in construction which is part of the problem in the sense of pushing up prices in parts of the Dublin area because there is such a weak supply response. At this point, we would not be concerned that there would be the kind of bubble that did so much damage in the past.

Deputy Richard Boyd Barrett: In my remaining two or three minutes, I will focus on that. At the heart of the Irish crisis, the European crisis and the global crisis was the issue of property becoming an area of speculation. I am seriously worried that what Professor McHale describes is a commentary on a boom-bust economy where we merely see which way it goes and where there are already signs that this area is becoming one for speculation again because there is no rational plan to balance supply and demand. My idea would be to build social housing which would put the unemployed back to work, provide affordable housing and regulate the market because it would keep prices from getting out of control. Instead, the Government is cutting back on all of those areas and handing over property, which was at the heart of the crisis, to big corporate speculators. That is terrifying. Would the fiscal advisory council be deeply concerned about that?

Mr. Sebastian Barnes: I will make a short point. Housing is the kind of area that can be dangerous and it is something about which we would not want to be complacent. As a factual point, what is significant is that the housing sector is far smaller than it was and is playing a much smaller role in the economy than it was at the top of the boom. For example, one of the uncertainties around the forecast is about what happens to housing investment but the truth is the level is so low right now that it does not matter a great deal for GDP. Of course, there might be dynamics under there which we should think about, and we certainly do, but it is not at the heart of the economics, as it was five years ago. Although I do not want to be complacent about it, mechanically, it has got back into its box for now and it is a somewhat different issue from what it was then.

Dr. Donal Donovan: I have two points. It is important to realise that the Irish crash and crisis was not due *per se* to the fact that Ireland was a small open economy. During that period and earlier periods many small open economies managed their affairs quite well and did not encounter what we encountered. The reason ours was a problem was because we failed to understand and follow the right policies that were needed in a small open economy to protect the banking system, to regulate the banks, to pursue prudent budgetary policies. It was not the small open economy *per se*; it was the failure of Irish policy-making to do what is needed to make a small open economy work and get the advantages without the disadvantages. That is, perhaps, a personal view.

My second point, on the property-----

Deputy Richard Boyd Barrett: Would it be fair to say that a part of that policy failure was letting speculators in various areas off the hook and letting them run riot?

Dr. Donal Donovan: Yes, of course. This brings me to the second point, on the property bubble. Throughout history, for a genuine bubble to last for a significant period one must have credit policies - one must have persons giving out money in order to finance speculators, etc. As Professor McHale pointed out, in the Irish situation there is no credit bubble. There is hardly any credit. What appears to be happening is that those who had accumulated savings, Irish expatriates and others who lived abroad and those who had sold property at the height of the boom - one must remember that for everybody who bought a property, somebody sold it and the money went somewhere - may now be coming back into the market because a high proportion of the sales are in cash. While it is a source of potential worry, socially and otherwise, it does not fulfil the typical conditions of a classic extended bubble in the way that property bubbles in other countries over decades have taken shape.

Acting Chairman (Deputy Dara Murphy): I call Deputy Creed. As this is the second round, I suggest approximately five or six minutes.

Deputy Michael Creed: I will try to be brief. I welcome these exchanges. There has been some commentary about the variation between the fiscal council's position on the lack of a credit line on exiting the bailout and the Government's. In fact, it is that dynamic that makes the fiscal council valuable. We need to maintain fiscal sobriety in this debate and dampen down expectations because with talk of exiting the bailout there is almost a daily commentary about when we can roll back some of the austerity measures that have been implemented. It is important that the fiscal council's voice is heard, clearly and critically, and if that involves criticism of Government, so be it. I would think on balance that exiting without a credit line is defensible but that is not where I want to concentrate my questioning.

I will focus on two issues in how the fiscal council evaluated the increased risk without a credit line of not reaching our targets, going from 30% to 50%. One is the proposed repayment by the Bank of Ireland of €1.6 billion of debt to the State. Was that an issue that was in the matrix of the fiscal council's calculations at the time? Is it a relevant factor? They might comment on that.

The other issue, which is on the other side and which might be a jolt to the public finance, is the slowdown in the sale of public assets. We are led to believe, for example, that the sale of Bord Gáis may not now proceed as anticipated. For a start, I ask them to address those two issues, where they may or may not have been the focus of the fiscal council's decision making.

Dr. Róisín O'Sullivan: On the issue of changing from a one in three to a one in two risk, that was purely a technical exercise based on the change in the size of the consolidation in the budget. That is what changed the risk around the central forecast. Really, it was not related at all and did not take into consideration the kinds of matters of which Deputy Creed spoke.

Deputy Michael Creed: In terms of how they contribute to the level of indebtedness of the State, are the factors in play relevant in terms of a revision of the risk that the fiscal council attributed at that stage?

Dr. Róisín O'Sullivan: When we look forward and revise our central growth forecast, the position of that central tendency will reflect these factors and then we will have a band of risks around that again.

Deputy Michael Creed: I was interested in Professor McHale's commentary to my colleague, Deputy O'Donnell, on the issue of how the ESM might be used in respect the statement of the 29 June 2012 EU Heads of State meeting which referred to breaking the link between sovereign debt and banking debt and how we might get back some of the money put into the Irish banking system by the taxpayers. If we will not get a straight-up injection from the ESM or elsewhere to deal with the public funds that were put into the banking system to save the euro at the time or take a hit for the team, is it a political or an economic judgment by Professor McHale that the ESM is unlikely to be used to skin the cat a different way in respect of getting something back for the taxpayers? There is a strange fit. If the 400,000 tracker mortgages worth approximately €70 billion were taken off the balance sheets of our banks, it might be another way of dealing with the 29 June 2012 statement by the Heads of State. Is Professor McHale's observation to Deputy O'Donnell a political judgment or a commentary on the architecture of the ESM that it is simply not feasible?

Professor John McHale: Before getting to that question, I will come back to the question on increased risk. Dr. O'Sullivan is correct on the analysis of the risk of not meeting the target. Another source of risk is that there could be a flare-up of the eurozone crisis. Deputy O'Donnell is correct that interest rates are currently low and have come down more recently, but we cannot rule out the possibility that there could be a flare-up of the crisis again. We know from experience that matters can turn quickly and one cannot merely go with the fact that current rates are low and then think that we are completely out of the woods and will be paying those rates forever. We must think about the bad scenarios and how to self-protect against them. In the report we look back to the experiences of countries that have gone through crises, particularly the Asian countries, and what they did to protect themselves in terms of accumulating cash balances, negotiating precautionary credit lines and good maturity management of the debt to limit the risks. In that context, we examined the precautionary credit line. We must look beyond the current bond yields.

Acting Chairman (Deputy Dara Murphy): I need to press Professor McHale on the point about political analysis.

Professor John McHale: It is a judgment about European politics in this case and not really an economic analysis but analysis of the willingness to make these transfer payments. It seems to be limited. While I support doing what we can to get it and while whatever success could be achieved would be very good from an Irish perspective, a personal political judgment is that it is unlikely. That is not a council position.

Deputy Michael Creed: We trespass on economic policy so Professor McHale is welcome to trespass on political analysis. Can Professor McHale comment on the defensibility of the banks considering raising interest rates for variable rate mortgage holders when the ECB is considering decreasing interest rates? This is because the banks are losing their shirts on the tracker books. Is that economically indefensible?

Professor John McHale: Variable rate mortgage holders are in a vulnerable position, particularly those in negative equity who cannot re-finance the property if banks try to push up interest rates. From a policy perspective, it needs to be examined closely. When banks come under severe pressure on profitability, partly because they are carrying tracker mortgages on the books, they will look for ways to increase profitability and variable rate mortgage holders are vulnerable. This is not something we have discussed at the council so it is my personal position as an economist rather than a council position. We have not yet come to the point where regulation is needed but it could be needed in future. Recognition of the vulnerability of variable rate mortgage holders is important.

Professor Alan Barrett: Can I make a quick intervention on the banking issue? Ordinarily, when asking a bunch of economists whether they are worried about something like this, they will talk about competition in the marketplace. An interest rate is just another price and, in the same way as we do not worry about price of bread, we think competition will sort it out. However, the tricky issue here is that the exit of foreign banks means competition has been removed from the Irish market. When economists talk about these things, they are reluctant to intervene through regulatory mechanisms on the assumption that competition should look after it but it is not clear there will be a strong competitive element in the Irish banking system for quite a while. It is an issue we must keep an eye on and economists will have a more nuanced view of it. I am sorry Senator Barrett missed my intervention, my communistic remarks on banking.

Deputy Michael Creed: I encourage the council to pay greater attention to the matter, which is a source of extraordinary concern to variable mortgage holders.

Deputy Kevin Humphreys: I thank the council members for attending and I wish them a happy Christmas. I am also a member of the Oireachtas Joint Committee on the Environment, Culture and the Gaeltacht. During June and July, that committee tried to design an expert advisory group on climate change to mimic the Irish Fiscal Advisory Council structure. It is quite a compliment to the council that we are trying to repeat the experience of the commentary we get here. It is not necessarily the case that I always agree with the Irish Fiscal Advisory Council.

There is an increase in the price of property in the Dublin area but my analysis is that it is a question of supply rather than a bubble. There is limited supply, with very little being built in the area in the past seven years. The number of units coming on stream mean there are very few two-bedroom family units. That is driving the cost. A tie-in question is that everyone is frightened of the construction industry bubble. My analysis is that the construction industry is operating at too low a level for a sustainable economy and I question how we can rebalance it. There is a need for properly sized units within the Dublin region. My analysis is that the construction industry needs to be brought up to a sustainable level. Has the Irish Fiscal Advisory Council examined the matter?

Professor John McHale: That is not something we looked at in particular. The Deputy's analysis sounds right in that it is a supply constraint problem. In addition to the factors listed by Dr. Donal Donovan on diagnosing a bubble, it is when people are buying because they are extrapolating recent price increases to continue indefinitely. If we see evidence of that, particularly if it is underpinned by strong credit growth, that is worrisome but I do not get the sense that the particular dynamic has begun yet. The Deputy is correct that the construction industry is operating at a reduced level and house building is way below historical norms. Professor Alan Barrett has a better sense of the figures. An overly expanded construction sector did damage in the past but we are very far away from it now. It would be welcome to see the supply response, which need not come only from the private sector and could involve public investment. We see low levels of investment, not just capital expenditure by the private sector but also by the public sector. There is scope for both. At this point in time, a strong supply response coming from the construction sector would be welcome.

Professor Alan Barrett: This relates to banking issues. One of the big worries is that builders interested in building will not be able to raise finance to do so. This feeds into the issues raised earlier and discussed at the committee previously. It is one of the market failures whereby people who want to build will not be able to move in. This raises the question of whether there should be more proactive State engagement. It is a very difficult thing to design but we cannot completely ignore it as a problem.

Deputy Kevin Humphreys: We also see rents exceeding mortgages, which is another sign of something wrong with the market.

Acting Chairman (Deputy Dara Murphy): The Deputy has one minute left.

Deputy Kevin Humphreys: I have a little more than that because I did not take 12 minutes in the first round.

Acting Chairman (Deputy Dara Murphy): The Deputy did not have 12 minutes in the first round.

Deputy Michael Creed: Deputy Dara Murphy does not have to be as tough as the Chairman.

Deputy Kevin Humphreys: Rather than argue, I will ask two questions quickly.

Acting Chairman (Deputy Dara Murphy): The point is that if the Deputy is not at the meeting, he cannot take the minutes.

Deputy Kevin Humphreys: Where does the Irish Fiscal Advisory Council see the level of domestic savings in the economy? Is it too high or is it about right? This ties in with what Dr. Donal Donovan was saying about the lack of confidence in the economy. When there is a lack of confidence, the savings rate is too high and when there is more confidence, the savings rate is lower. It is an important indicator of what will happen with the domestic economy and the retail sector.

Professor John McHale: On the subject of savings, economists can be schizophrenic. In the long term, savings are good because the amount of investment is very much linked to the amount of savings a country does over long periods of time. In the short term, an increase in savings and a reduction in consumption can be a major contractionary drag on the economy. We spoke earlier of this balance-sheet recession, part of which has been a big rise in savings as householders try to repair their balance sheets. They also became more concerned about the future so they engaged in more precautionary savings, trying to protect themselves - just as we talked about the State trying to protect itself. We therefore saw a huge spike in the savings rate which was a major recessionary force.

We are starting to see the savings rate come down but it is still at elevated levels compared with what it was going into the crisis. The likelihood is that as confidence returns, and if the kind of momentum we discussed earlier continues, it should fall further. A lot of interesting international work has been done by examining the US savings rate which had also gone to very low levels pre-crisis. They do not anticipate that it will return to those levels. It will come down from the current elevated levels and that is already happening. I would anticipate therefore that as long as the good momentum continues, there should be further falls in the savings rate that will boost consumption as well as further boosting the economy, disposable incomes and employment. It will get a virtuous cycle to work, but I do not anticipate that the savings rate will go down to the lower levels, as was the case pre-crisis.

Deputy Kevin Humphreys: Where does that equation work into Professor McHale's recommendation on the consolidation of the €3.1 billion? If we reduce domestic savings and increase the spend in the retail sector, it has an immediate effect on employment figures, as we have seen. The 9.5% VAT rate had a significant effect on people in employment. Spending in the domestic economy immediately triggers into jobs. The balance within the budget cycle is trying to generate that confidence.

Acting Chairman (Deputy Dara Murphy): I have to press the Deputy, to be fair to other members of the committee.

Deputy Kevin Humphreys: When Professor McHale makes his recommendations, does he factor in the effect of people's confidence?

Acting Chairman (Deputy Dara Murphy): I am sorry but Professor McHale should be brief.

Professor John McHale: What we are getting at is the key trade-off we examine when we think about the appropriate fiscal stance. On the one hand, we absolutely recognise that more fiscal adjustment hurts the economy in the short term. It reduces demand which is not what we need at the moment. If there were no other constraints we would be calling for less fiscal adjustment, not more. We also know that, not that long ago, the Irish economy lost its credit worthiness. There were real risks of default. The implied probability of default in mid-2011 was close to 90%. If Ireland had defaulted, the international evidence indicates - even though it does not always speak with one voice - that the costs of defaults are very large. It would send the crisis into another vicious phase.

One way to help regain that credit worthiness and avoid default is to improve one's fiscal position faster. Even the fear of default raises interest rates, which have knock-on effects on the banking system so in itself it can be contractionary even in the short term. This was the balancing act that underlay our thinking about what the appropriate fiscal stance is. Over time that trade-off is changing and the State's credit worthiness has been substantially restored. However, it goes back to some of the risk factors we discussed before. We do not want to undo many of those benefits by starting to miss key targets. There is also ongoing uncertainty concerning the eurozone so the crisis could flare up again. We are continually re-evaluating that particular trade-off.

Members of the committee may recall that we had been calling for more adjustment in the past at a time when the State was clearly not credit worthy and that trade-off was much less favourable. We have eased back on what we have been recommending in terms of adjustment. The key now is to hit those key targets we have agreed to. As regards the Deputy's basic point on the importance of supporting demand in an economy that is still in recession, we are in full agreement.

Senator Sean D. Barrett: I welcome the members of the Irish Fiscal Advisory Council. The last time we were here it turned out that I had taught everybody except one member of the delegation, so I had better praise their work.

Professor McHale's own role was a troika suggestion which I strongly supported. Does it enhance his role when the troika has left? Will he still have contacts with them? Will he be consulted in the preparation of the new national development plan? When I tabled amendments to the Finance Bill that Professor McHale's council should be consulted, the Minister for Finance, Deputy Noonan, was quite willing to consult it but the departmental officials said it was not in the council's mandate. They also said the council would seek a bigger budget if its advice was sought. Will the Department of Finance try to absorb the council or does it respect the council members' independence and professionalism, which I do?

Professor John McHale: That is a great set of questions. The idea of a fiscal council predated the troika programme and Senator Barrett was involved in those early considerations of the council. It certainly became a condition of the programme then. To a large extent, because it was already in the works, it would have been required anyway under European fiscal rules.

Our importance certainly increases post-troika. They were the main watchdogs for the last couple of years but our watchdog role takes on great importance post-bailout. The troika will continue to visit, however, and hopefully will continue to want to see us. We envisage that those links will continue.

As regards the medium-term strategy, the officials are right. We have a particular mandate and it is possible that it will be extended in future. For the credibility of the council, however, it is important that we do not exceed that mandate, which is focused on an assessment of the projections, compliance with fiscal rules, assessment of the fiscal stance, and importantly this new endorsement function relating to the macro-economic forecasts. As an individual NUIG economist, I was asked to a seminar on the medium-term strategy, so I was able to give my views but not as a council member.

For some reason, I was taking very bad notes and I only seem to have scribbled down the Senator's third point. Can he remind me of what it was?

Senator Sean D. Barrett: I think Professor McHale has captured the points. I appreciate his work on the multipliers. As legislators, we get examples all the time whereby if a certain amount of money was given to project X, some 84 million people would immediately be employed. Professor McHale's work on trying to put some sense into that is valuable. It should be widely distributed to Deputies, Senators and senior civil servants. I find that most of the sectoral Departments have been completely unreformed since 2008. As a professional outside body, the Irish Fiscal Advisory Council has to draw attention to that from time to time. If all the bits add up to an unsatisfactory macro performance, the same people who crashed the economy in 2008 could be back for an encore. I therefore welcome what Professor McHale has said on that.

I would echo what Deputy Boyd Barrett said about the Finance Bill and property bubbles. I do not know how good we are about Keynesianism these days. In the United States a stock exchange bubble is threatening noises if quantitative easing is relaxed at all. It is main street versus Wall Street. I would be afraid of starting a property bubble again and I echo Deputy Boyd Barrett's sentiments in that regard. Part of it must be that there is no rate of interest on savings so, in fact, we are diverting savings into bubbles. That is a consequence of the ECB's policy of not paying anything on savings. In that context, are the other eurozone countries aware of, or have they addressed, this question whereby not paying interest on savings will lead to property bubbles? We were the blatant example.

I am absolutely delighted with economic growth of 0.2% and 3.8% employment growth, but does Professor McHale have any thoughts on that? It is terrific that it has happened. Professor Alan Barrett used to write about jobless growth by growthless jobs. Is this sustainable? Has the delegation thought from its work in other countries as to what happens at this stage when one gets this employment boost? The boost is due mainly to self-employment rather than in the traditional sectors.

Professor John McHale: We are very aware of the property bubble. We are avoiding the mistakes made in the past. We will come away from this meeting with that concern reinforced and will be on the case.

Professor Alan Barrett: As one of those taught by Senator Barrett, I am reluctant to criticise the teacher. Let me have a small go at him, however.

Deputy Kieran O'Donnell: Professor Alan Barrett has been waiting for years for this.

Professor Alan Barrett: That is true.

(Interruptions).

Professor Alan Barrett: Senator Barrett's argument that the ECB's policy on interest rates is wrong is extraordinary. What is needed is the combination of a low interest rate policy with sensible credit policies. What went crazy previously was that any sort of credit control was thrown away. There is a whole host of proposals such as loan-to-valuation limits and earnings limits in place now. There is a plethora of policy instruments that allow a low interest rate environment while at the same time capping crazy housing expenditure.

On the issue of growthless jobs, a nice new phrase, the employment numbers are spectacularly positive while the gross domestic product numbers have been spectacularly neutral. Clearly, there is a conundrum. The patent cliff seems to be causing difficulty in trying to disentangle what precisely is going on in the growth numbers. We knew for some time that these were jobs with phenomenal rates of productivity attached to them which no one really believed. Obviously, there was something funny going on in the accounting.

The patent cliff is hitting so it seems to be biting into the gross domestic product numbers, yet there seems to be real activity. The nice point of the job numbers is that they are predominantly full time. I do not think they are predominantly in the self-employed sector. Some of the earlier upward trends in employment were related to part-time work. My guess is that the more recent employment trends will show up in the gross national product figures. They are real jobs and there is real growth underpinning them.

The great frustration over the past several years is that every time positive numbers for employment appeared on the horizon, they tailed off later. That is more a European phenomenon than an Irish one. It is good to welcome the good news but it is important not to lose the run of ourselves in thinking we are on a straightforward, linear upward trajectory.

Mr. Sebastian Barnes: This productivity puzzle is not just an Irish problem. The UK has the same issue where gross domestic product is catching up. Employment there was a mystery as it was growing very fast but the economy was doing very poorly. US productivity has the same weaknesses seen here. We are in a pretty unusual situation economically with this very long recession and part of these uncertainties are the distortions created by the measures to boost demand by quantitative easing. We see an upside risk.

Deputy Lucinda Creighton: This is one of the most interesting committee meetings I have attended. The clarity is very helpful and it behoves all members to listen to what has been said. The advent of the Irish Fiscal Advisory Council was necessary and it is proving itself to be genuinely independent. I commend its members on the work they are doing and it helps us in our task as parliamentarians. I share some of the concerns the council has expressed in recent months, particularly around the bailout exit.

I have researched access to OMT, outright monetary transactions, but it is still somewhat hazy. The European Central Bank guidelines are very clear in that in order to access OMT, a member state must be either in an ESM programme or availing of a credit line. I am concerned that when we exit the bailout without a credit line, we are actually cutting ourselves off from OMT. We are all aware of the impact of the statement by the ECB's president, Mr. Draghi, in 2012 in stabilising the euro and bringing down bond yields for Ireland and other eurozone countries. I hope we do not need the OMT lifeline but basing important economic decisions on hope has not served us well in the past.

Professor John McHale: OMT is an enigma. As Deputy Creighton said, it appears to have been effective in bringing down bond yields. However, no one really knows how it would work in practice. The ECB seems to be happy keeping people guessing. It is designed for a more systemic crisis and seems to be focused on the problems in Italy where a bailout programme would not work because it is too large. If Italy got into trouble, one can see the problem spreading which could affect Ireland. The guidelines state that in order to access OMT a member state needs to be in a programme or be part of precautionary programme. This would protect us against risk even though OMT has not been designed with a country like Ireland in mind.

Dr. Donal Donovan: I think Deputy Creighton's description of this as hazy is correct. There is only one record of this which was issued after the decision which was some time ago. Based on recent reports, it could be that there has been some evolution or divergence in thinking in the upper echelons of the ECB. This is not entirely clear based on the reports one heard and these included subsequently a very specific restatement by the vice president of the ECB, Mr. Rasmussen, reiterating the original piece of paper. As Professor McHale says, all we have is a piece of paper and that is all one can go on unless and until something new happens.

Deputy Lucinda Creighton: I thank Dr. Donovan. That was very clear.

Acting Chairman (Deputy Dara Murphy): We are now moving into the supplementary rounds. I will take them in the order people indicated.

Deputy Richard Boyd Barrett: I welcome the fact that the witnesses have responded positively to the issues surrounding the dangers of the property bubble. I raised the issue of real estate investments trusts last year at the budget and again this year. Could the witnesses comment on that? As I understand it, this is a model that has essentially been adopted from the US where there are worrying signs it could be producing a bubble. I think this is a very dangerous development. It also relates to a larger conundrum discussed here and the issue of growthless jobs, which we also discussed with the Department of Finance and which I raised with the Minister for Finance during the budget discussions. What the witnesses have said in summary is that we need growth to hit our targets but we cannot get growth without investment and we are not getting much investment because of the austerity requirements. This begs the question of who invests. As Dr. Donovan rightly pointed out, the only people who really have the money to invest now are those who made a fortune and were left standing after the crash. They are the only ones with money. They probably have access to credit. The little guy has no access to credit but they have access to it. What they are doing is buying up bargain basement stuff left lying around after the crisis. The very people who caused it are now buying up everything at the bottom of the market so they can start the whole process again. Government policy is facilitating that. That is a very worrying development because it is a recipe for spectacular profits for them rather than investment directed towards real growth in the economy.

Acting Chairman (Deputy Dara Murphy): Is there a question?

Deputy Richard Boyd Barrett: Is that not a very worrying development and is it not happening? There is a very simple explanation for growthless jobs which follows on from the same logic for growthless jobs, which is that workers who have had their wages slashed or were unemployed are now being employed at bargain basement prices. As a result of having very low wages and all these schemes where they get 20 quid on top of their dole, the unemployment figures come down but they do not contribute to growth and high street demand.

Professor John McHale: In respect of the Deputy's general point about the importance of investment to Ireland's recovery both in the short term, in terms of boosting demand given that investment is a key component of demand, and in terms of longer term growth driven by an increasing productive capital stock, investment is key. To improve the investment climate, one thing we certainly need is credit growth but credit being channelled to people who will make these productive investments. The Deputy makes an important and very relevant distinction between people who are just interested in investing in assets that are already there and those who wish to invest in new productive assets that will create more activity in the economy and support long-run growth. There needs to be a focus on investment and what the obstacles to it are. The most important thing at the moment is probably the credit system which requires that we have a well-functioning banking system which needs to be adequately capitalised.

It may be a little unpopular to say this but Japan made a huge mistake when it went through a similar crisis. In an early phase of the crisis, the state had to put capital into banks and there was a huge public backlash as one would expect and which certainly occurred here. In the later stages of the crisis, the banks again got into a lot of trouble. They were severely under-capitalised which was having a very adverse effect on their credit system and, ultimately, on levels of investment in the economy but because there was such a huge backlash to the earlier capital injections, it left the banking system severely under-capitalised. The hope would be the banks do not need more capital but we must see what happens when the ECB's comprehensive assessment takes place next year. We certainly hope that whatever capital needs there are would come from the private sector and failing that, from the ESM. Due to the fact it is so critical to have a well-functioning banking system and because a properly and adequately capitalised banking system is so central to that functioning, it is something that will have to be looked at carefully and not left under-capitalised because of the very bad hangover from the huge amounts of capital that went in before. The Deputy's general point about focusing on investment and what might be holding it back is very important.

Mr. Sebastian Barnes: I just wanted to comment on investment because investment projections are actually quite strong. There is obviously a very important issue around investment in the domestic economy. One of the upsides of Ireland's openness is precisely the ability to attract capital from other places and the fact that this means that much of the productive investment in the economy is not particularly reliant on the domestic banking system but reliant on the international banking system. The international banking system is not doing a particularly good job either but, on average, it is in better shape than the domestic system. Coming from the outside, I find it surprising how strong some of the machinery of investment has really been, once one strips out the aircraft. Ireland seems to be relatively successful at capturing a disproportionate share of the investment that is going on around the place. That is a positive notwithstanding the domestic problems.

Professor John McHale: From a low base.

Deputy Kieran O'Donnell: I have two quick questions. The council has reduced its assessment of the likelihood of Ireland breaching the 3% debt-to-GDP target by 2015 from one in three to one in two. Where does the council see the possibility of reaching the growth target of

2% for 2014? Did it put a physical measure on that? In respect of the analysis of the forecasts, did the council factor in the patent cliff and the question of how GDP is now being measured? Is there a possibility that the methodology used to measure GDP is flawed? It has a huge impact because growth determines everything for us as a country, particularly when we are on the trajectory of coming out and meeting targets. Growth is the key factor on every level in terms of how the bond markets look at us and meeting the 3% debt-to-GDP target. I am asking a technical question in terms of how growthless jobs are being measured because historically there was always a lag behind the growth in GDP with jobs coming on stream? We now find the opposite is true but we are finding that they are real jobs and there is growth. I suspect this growth in jobs is not applying where an economy is in negative growth. I suspect it always happens in a situation where there is some form of growth so is the measure flawed?

Could the witnesses give me an actual measure such as one in three in respect of reaching the 2% growth target? The witnesses mentioned credit. Do the witnesses believe the banks are lending to SMEs?

Acting Chairman (Deputy Dara Murphy): The witnesses have thus far avoided putting percentages on its calls.

Deputy Kieran O'Donnell: It as if they have provided a paragraph with something in it and I am now asking them to put that same measure in another paragraph. I have no doubt they are capable of doing so.

Mr. Sebastian Barnes: I guess it will sound like an evasive answer when I say that the methodology we are using for the GDP charts, which is our main measure of uncertainty, is based on a symmetric construction. Upsides and downsides are the same. We have indicated that we believe the risks are on the downside. That means we think the probability of reaching it is less than 50:50. We do not have a quantitative measure for exactly how far this might be. In a way, it is somewhat meaningless because it does not matter that much if it is a little less.

Deputy Kieran O'Donnell: Mr. Barnes believes there is a one in two chance of reaching a growth rate of 2%.

Mr. Sebastian Barnes: It is somewhat less than that. There is a range of scenarios. We could miss it by a bit or we could be facing another crisis next year, triggered by events here or elsewhere. I hope we will not but realistically that is a possibility.

Deputy Kieran O'Donnell: Why is it to that level? The amount varies between 3.1% and 2.5%. It is an actual measure but, in terms of growth, fewer cuts are generally seen to have a slightly more positive impact. Why, then, is the same measure being applied?

Mr. Sebastian Barnes: There is consistency in that sense because we are already taking those effects into account. However, growth does not increase on a one for one basis for easing back on fiscal consolidation. The metrics around one third versus half are based on the uncertainty about GDP and everything working out mechanically in respect of the budgetary projection. Of course, if that happened there might be a policy response which would be taken into account, or money might be found through the Bank of Ireland or other routes. It is not allowing for that but it is saying that extra would be needed. An important question in regard to growth is why it might be weak. If it is because the recession, as a cyclical factor in the euro area, gets worse, it will delay sorting things out and make them worse in the transitory sense but we will get there eventually once the cycle turns back. However, if it turns out that the underlying economy in Ireland is permanently weaker than we think, it means we are in a worse state and the trade-offs will be worse. We hope we are not in that world.

Deputy Kieran O'Donnell: Is it possible that the measure of GDP is flawed?

Mr. Sebastian Barnes: The measure of GDP, subject to the normal measurement error, is basically fine but the question arises of how one interprets it. For most countries GDP is straightforward to measure and provides a good statistic. In Ireland, however, there is a big difference between GDP and GNP, which is more relevant. In a previous report the council used this hybrid measure. We should not completely ignore the difference because there is stuff going on that is real and the tax revenue that accrues is important and should not be ignored. At the same time, however, it cannot be treated like consumption.

Professor Alan Barrett: On the specific issue of the patent cliff, I will try to explain it but may just illustrate my own ignorance.

Deputy Kieran O'Donnell: Professor Barrett is being modest.

Professor Alan Barrett: One of the reasons for confusion is that the subsidiaries of the major manufacturers were, in a sense, purchasing the licence for products from their headquarters. It is not a simple case of buying and selling a product or service. They were trading licences relating to property rights. EUROSTAT would sign off on this way of operating because there is nothing mechanically wrong with it but it was very hard to understand precisely what was going on and how these things are then treated.

Deputy Kieran O'Donnell: Is it possible that growth was overstated in previous years?

Professor Alan Barrett: No, I think the numbers are absolutely fine but when these things fall out of the system, fully interpreting what is going on is very complicated. The measure is fine but the interpretation of it is difficult and, from an economist's perspective, merging the various data, such as employment and GDP data, is complicated.

Dr. Donal Donovan: In one way, the treatment of pharmaceuticals is not overly complicated. Exported pharmaceuticals are treated as exports. Imports are divided into two categories, raw materials and payment of patents for licences, which appears under services. There are, therefore, exports of goods, imports of goods and considerable imports of services called patents. One of the problems that arise is in the valuation, measurement and time period of the patents. If patents disappear over the cliff, presumably the exports will disappear but the imports will also disappear. In theory, the entire circuit would just stop if an industry ceased operations.

Professor Alan Barrett: It is slightly trickier in the sense that many of the companies concerned will continue to manufacture generic versions.

Acting Chairman (Deputy Dara Murphy): I ask for clarification on the timelines and the change from the predictions from one in three to one in two. These were post-budget but did not take into account the improved employment numbers announced last week and, of course, the Exchequer returns, which were better than expected. We may revert to one in three.

Senator Sean D. Barrett: Bearing in mind that when Mark Carney moved to the Bank of England from Canada, where he had a good performance record in macro-economics, his first act was to persuade the British Government to pull out property based investments of the kind that worried Deputy Boyd Barrett. Do the witnesses see us moving towards maximum loan-to-value and loan-to-income ratios? Banks used to loan up to 80% of value and 2.5 times income. A representative from AIB recently told the committee about a customer who had a debt of €340,000 and an income of €60,000. One of the questions we asked was whether the AIB employee who gave out the loan still worked there. How can we protect the economy from that kind of practice? Denmark has introduced strict rules and a number of countries changed the ratios for geographical areas. For example, higher ratios would be required in the south east of England if one believed a property bubble is emerging there. This will form an essential part of macro-economic management given what the sector did previously. Bankers definitely should have been regulated to prevent the behaviour that obtained under the previous system. We have a Bill on the Seanad Order Paper to provide those powers. The Governor of the Central Bank, Professor Honohan, stated to the committee on a recent visit that he does not possess the powers to prevent reckless banking. It was not meant to be a provocative statement.

Dr. Donal Donovan: This is a complicated issue. Until the late 1970s or early 1980s, the imposition of ceilings was the way banking was regulated in Ireland, perhaps to good effect. All of that went out of fashion and was discarded through much of Europe, although not in every country. Arguably, the absence of the ratios contributed greatly to the banking collapse. Following the crash, everyone took another look at this issue and I have a sense that many in the Central Bank would like to have those powers for use as backstops. I cannot comment on whether they have the powers, however. While I was involved in the Honohan inquiry, there was extensive discussion among people in the Central Bank about whether they had those powers. One might think it a straightforward question but it was not in fact straightforward. I imagine it is something the new European banking supervision authority would seek to discuss and consider. For such ratios to be effective they must be applied generally throughout the euro area. Otherwise there would be so many loopholes and escape clauses that they could not be effective. This could be on the agenda because not all European countries followed the Irish example.

Deputy Richard Boyd Barrett: Earlier we discussed the lack of credit coming from the banks. Do the banks have any interest in lending for productive investment when their capital position is being restored by the rise in property prices that is occurring? It seems to me that they do not.

Acting Chairman (Deputy Dara Murphy): The witnesses cannot answer for the banks, which are not represented here.

Professor Alan Barrett: I will take a stab at it. To the extent that banks are profit-maximising agencies and there are productive possibilities out there that will be profitable, they clearly have an incentive. One of the great worries is that there is a generation of people working in Irish banks who have loaned only into property and were very comfortable doing that. They were not the sort of bankers who were good at appraising projects and making sensible decisions about them. This is a legacy issue which we have discussed here before. The question is not whether they have an incentive but whether they have the capacity to assess the risk of projects and make decisions. There is still a sense that bricks and mortar seems much easier for these people.

To the extent that prices are on the way up again, if that is true, one would be terrified that default mode would be restored, lending into the old reliable, and that the productive possibilities are not there. We have touched on some of what needs to be done. Clearly there is a need for policy instruments on housing to ensure the bubble does not get out of control again. Proactively engineering lending in a particular direction will be very difficult in a situation where we have only two banks. There is a real fear that these guys will be able to make their money without extending themselves, which is what they did to a great extent in earlier decades when we had just two banks.

Acting Chairman (Deputy Dara Murphy): Do the witnesses have any closing remarks?

Professor John McHale: We are satisfied. I thank the committee for all the time it has given us. This is a very important part of what we do and we have found it enormously useful in our work.

Acting Chairman (Deputy Dara Murphy): We thank Professor McHale. There was a reference to whether IFAC was being ignored. It is important to emphasise that the vast majority of its advice is taken, and there will be some interest in the other areas where it is taken on board but not fully carried through. It is particularly welcome to hear IFAC getting feedback from us and trying to engineer housing construction and housing supply without recommencing a bubble. That problem will have to be addressed by everybody. I thank the witnesses for attending and look forward to seeing them again in the very near future. I wish them the best with their work, particularly over the next number of months when they have European obligations on our behalf. I also thank the people in the gallery for attending.

The joint committee adjourned at 4.35 p.m. *sine die*.