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Restoring Credibility in Policy Making in Ireland

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Abstract: This paper first considers the origins of the Irish economic crisis. It discusses where the policy failures occurred, to what extent they were foreseeable, and how certain key financial institutions performed in the run up to the crisis. In the light of this analysis the paper then considers what institutional changes could feasibly be implemented which would strengthen policy making for the future.

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Restoring Credibility in Policy Making in Ireland

1. Introduction

Ireland, having been perceived as the EU success story from the early 1990s, has now fallen from grace, with the country experiencing a dramatic decline in fortunes since 2007. The current crisis has seen living standards returning to the levels last seen a decade ago. The economic causes of the reversal are reasonably well understood. The dangerous position of the Irish economy in the middle years of the last decade was not hidden from view. However, the government and the regulators of the financial system in Ireland, instead of acting to offset these dangers, actually stoked the fires leading to an even bigger crisis when the bubble finally burst. This paper considers the policy failures that contributed to the economic disaster and discusses some of the suggested institutional changes which are aimed at preventing any repetition at a future date.

Section 2 of this paper briefly describes the origins of the crisis while Section 3 considers the policy failures which brought this about. The remedies for this policy failure are then discussed in Section 4.

2. The Origins of the Economic Crisis

The essential context within which the recent Irish economic crisis has occurred is the formation of Economic and Monetary Union (EMU). Because an independent monetary policy was no longer possible within EMU this called for a change in the role of fiscal policy in Ireland (and in other EMU members). Prior to membership of EMU, if the economy suffered a major shock resulting in unemployment the exchange rate could change to help restore competitiveness; this is no longer possible under EMU. In addition, under EMU monetary policy can no longer be used to cool domestic inflationary pressures, especially pressures in the property markets. Instead governments of member states in a monetary union have to rely on fiscal policy to undertake this task. This change in the role of fiscal policy was not adequately recognised in Ireland by either the government or the regulators of the financial system. The result was the development of a very serious property market bubble.

Signs of danger

With the commencement of EMU in 1999 the state of the balance of payments of individual member states fell from policy-makers' oversight. While both Ireland and Spain largely complied with the requirements of the Stability and Growth Pact (SGP)[1] before the crisis, they have seen a critical deterioration in their public finances since the recession hit. The SGP was no guarantee that all was well in those economies. What clearly signalled the growing internal problems in those economies was the growth of their balance of payments deficits over the course of the last decade. Blanchard, as early as 2001, identified this as a problem for Spain and, writing in 2007, he showed that even with rational and well-informed markets (no bubbles), governments of individual member states in EMU should care about balance of payments deficits.

From the start of EMU, balance of payments deficits due to private sector over-investment (or under-saving) were considered to be very different from deficits due to government excess borrowing – private debt was not perceived to be a problem whereas government debt clearly was. This was because it was assumed that if elements of the private sector found that they had borrowed unwisely they could default without major domestic or international consequences. However, we have seen how the financial crisis showed governments that they could be made liable for private sector excesses as they faced the awful alternative of collapses in their financial systems.

In Ireland the balance of payments on current account deteriorated rapidly from 2003 through to 2008, peaking at a deficit of 6.6 % of GDP (Figure 1). The four EMU members which have experienced serious problems in the current crisis all had serious balance of payments problems reflecting the imbalances in their domestic economies. Thus the best single predictor of future danger was the state of the balance of payments, not the state of the public finances. The concentration on the public debt, with no attention being paid to the balance of payments saw policy mistakes going unrecognised in Ireland and Spain.

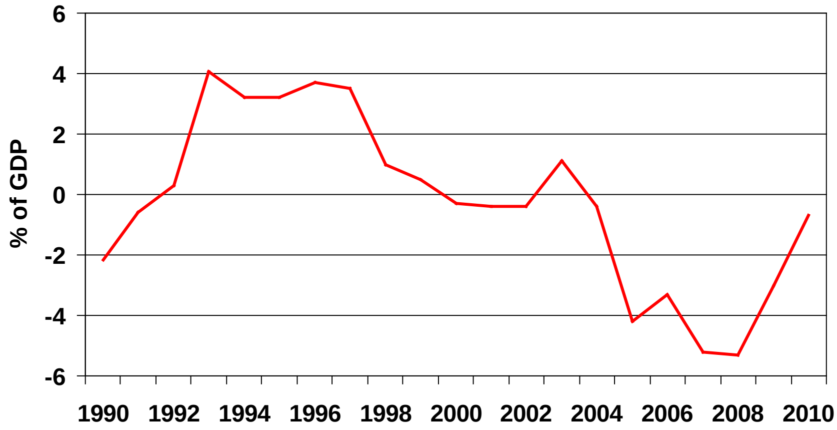
This lesson should be learned by policy makers in the EU when designing new rules for good fiscal behaviour. For the future governments need to be concerned about unwise financial behaviour of their citizens, especially where it is manifested in a growing balance of payments deficit. In the case of both Ireland and Spain the rising deficits were a clear indication that the exporting sector of the economy was being crowded out by the growth of the building and construction sector. The counterpart to the current deficit was a capital inflow through the rapid growth in the net foreign liabilities of the domestic financial systems (Figure 3). It was this exposure of the financial system which has greatly aggravated the current problems for the Irish economy.

Under EMU, while monetary policy was the preserve of the ECB, responsibility for the regulation of the financial system still resided with national regulators. Thus, when the Irish regulator failed to prevent a crisis developing in the domestic financial system the Irish government was responsible for resolving the situation and ensuring that a catastrophic collapse in that system was avoided.

[1] The SGP aimed at controlling government borrowing.

Though the ECB has provided major support for the Irish financial system in terms of liquidity, the assumption by the State of responsibility for the Irish banking system's losses has turned a huge private sector loss into a huge government sector loss. While there is considerable debate as to how much of these losses the State needed to take responsibility for, experience with past financial crises of this kind indicates that this translation of a private sector loss into a government sector responsibility is not unusual. Though the experience of Ireland has been the most extreme within the EU, many other countries have found themselves absorbing some of the losses of their banking systems through different mechanisms.

Figure 1: Balance of Payments Surplus



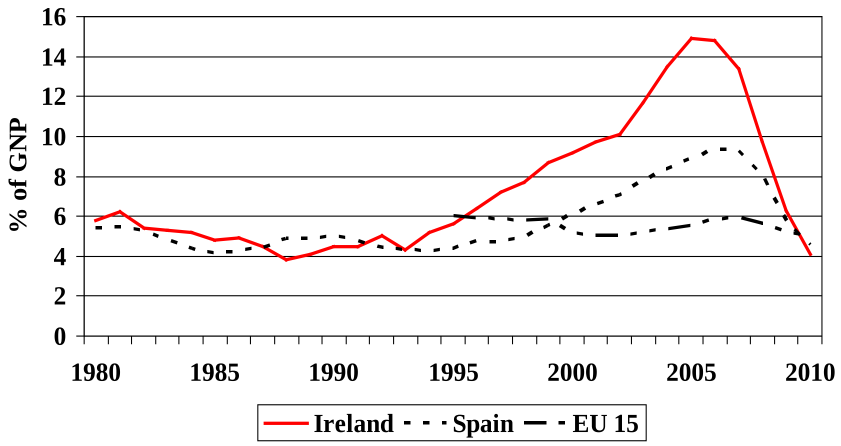
The Bubble

Ireland at the end of the 1990s was experiencing very rapid growth in output driven by rapidly rising export demand. This reflected the fact that the economy had restructured itself over the 1980s and early 1990s to restore competitiveness (Honohan and Walsh, 2002). One consequence of this boom in exports and output was that the economy was running into infrastructural constraints by the end of the 1990s. Rather like a child that had outgrown its clothes, it needed investment in infrastructure across a range of areas to cater for the increase in economic activity (FitzGerald, 2002). In particular the poor quality of transport infrastructure was in danger of strangling growth.

Private infrastructure in the form of housing was also a major constraint. Because the birth rate peaked in 1980 the last twenty years have seen a very big increase in the population in their 20's, the age at which individuals begin to form their own independent households. With a relatively small population over 70, due to past emigration, there were relatively few houses being vacated to make space for the new generation. The result was huge pressure on the existing housing stock and rapidly rising prices in the late 1990s (Bacon *et al.,* 2009). The boom in the economy also meant that many Irish emigrants returned and many foreigners came to work in Ireland, putting further pressure on public and private infrastructure.

As discussed in Conefrey and FitzGerald, 2010, there was a real need to expand the house building sector to meet the population needs. The problem was that this expansion of activity got completely out of hand. As shown in Figure 2, investment in construction of housing peaked at 12% of GDP in 2007.

Figure 2: Housing Investment as Share of GDP/GNP

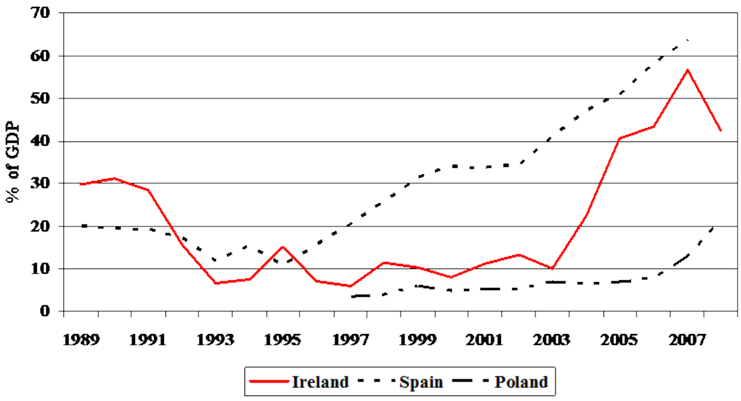


The bulk of the additional resources required to fuel the increase in output of the building and construction sector of the economy had to come from other sectors of the economy. The key signal to the labour market about the need to reallocate resources from the export sector to building and construction was a change in relative wage rates and prices of other inputs. The resultant reduction in the supply of labour available for sectors, such as manufacturing, meant that employers in the exporting sector had to compete by also raising their wages. This resulted in a continual loss of competitiveness of the economy over most of the last decade, as documented in the annual reports of the *National Competitiveness Council*.

Just before the bubble burst in 2007 housing investment accounted for 12% of GDP and building and construction investment accounted for around 20% of GDP (and 14% of employment). As shown in Figure 2, the housing share of GDP was dramatically higher than that in the EU 15 in recent years and even much higher than in Spain, which has also experienced a major housing bubble.

The result of this excessive exposure to the building and construction sector was that when the bubble burst in 2008, even without the financial collapse, a major adjustment in the economy was inevitable (FitzGerald, *et al.*, 2005). For the newly redundant resources in building and construction to be reabsorbed elsewhere in the economy there had to be a major improvement in competitiveness so that the export sector could reabsorb these resources.

Figure 3: Net Foreign Liabilities of Banking System



The second strand to the Irish crisis has been the failure of the financial sector through its financing of the huge investment in building and construction generally, and in housing in particular. While domestic savings were sufficient to fund the housing boom up to around 2003, thereafter they proved increasingly inadequate. Instead, as shown in Figure 3, the banking sector financed the boom by borrowing increasing sums abroad and relending these funds as domestic mortgages. Because the foreign borrowing by the banks was undertaken on a short-term basis, while the lending on mortgages was long-term in nature, this left the banking sector increasingly exposed to any shock. The regulatory authority permitted this dramatic increase in exposure.

When the bubble burst the result was a dramatic loss of confidence in the Irish banking system. In turn, this saw the banking sector unable to fund itself abroad and the consequence today is a very high dependence on the ECB for liquidity.

3. Policy Failures

In considering the current economic crisis in Ireland it is useful to look back and consider the source of the policy failures. To what extent were wrong or dangerous policies adopted since 2000 because of a lack of information about what was happening and how the economy worked and to what extent was it due to a failure to follow good policy advice? The answer to these questions can help develop a more robust policy-making process in the coming decade.

As discussed above there were two major policy failures that contributed to the current Irish economic disaster. (Ireland could not have prevented the world financial collapse, which has contributed very significantly to the economy’s current woes). The first was the failure to ensure that the domestic financial system was operated in a prudent manner and the second was the failure to manage domestic demand, in particular the failure to prevent the development of a property market bubble. If either crucial element of economic policy had performed adequately there would probably have been no bubble to burst.

Failure of Banking Regulation

With the benefit of hindsight the collapse of the domestic financial system could and should have been prevented, firstly by the management and boards of the commercial banks (Nyberg, 2011) and, secondly, even in the face of the collective madness of those running the banks, by the financial regulator who should have seen the dangers and prevented the disaster (Regling and Watson, 2010).

The complete failure of the financial regulator to either see the increasingly dangerous exposure of the financial system from the middle years of the decade or to take action to prevent it has resulted in the collapse of the domestic financial system. Honohan, 2010, supplemented by Regling and Watson, 2010, has documented the problems and failures in the regulatory system. Some of the problems arose from following the UK model in splitting responsibility between the Irish Financial Services Regulation Authority (IFSRA) and the Central Bank. Also the assignment of some responsibility for "developing" the Irish financial sector to IFSRA had an adverse impact. However, the weakness of the regulatory authority in dealing with the banks went far beyond "light touch regulation". While similar problems have become apparent in many other countries, such as the UK, the US and Germany, the consequences have been much more severe in Ireland.

For those working within the financial system it was not easy or realistic to expect them to cry foul in public about the weak response of regulation. It is certainly clear that, even if they had misgivings, they did not act on them in managing their own businesses (Nyberg, 2011). However, the wider academic community also paid little heed to these risks. When warnings were issued, as they were, for example, in the ESRI *Quarterly Economic Commentary* in Spring, 2007, the Department of Finance failed to draw them to the attention of the Minister.[2] Similarly those doing research in financial economics tended to concentrate on areas of interest other than financial stability.[3]

The Department of Finance, like the academic community, also relied on the regulator over the same period, allocating very limited resources to monitoring developments in the financial system (Wright, 2011). This failure of the Department of Finance to attempt to second guess the regulator was quite understandable up to late 2007 – the regulator had

[2] Nyberg, 2011, disclosed the briefing provided by the Department of Finance to the Minister on the ESRI QEC: "The Spring 2007 QEC also noted that if the astonishing growth in net foreign borrowing by Irish credit institutions since 2003 had been used to fund the ongoing boom in the housing market, the situation was not sustainable. This particular point does not appear to have been followed up by the DoF or brought to the attention of the Minister."

[3] The work of Honohan was a notable exception (Honohan, and Klingebiel, 2003).

the assigned task under law. However, the problems that were by then becoming apparent should have caused the Department to become much more demanding of the regulatory authority in early 2008 and to prepare the ground better for the financial crisis that ensued in September 2008.

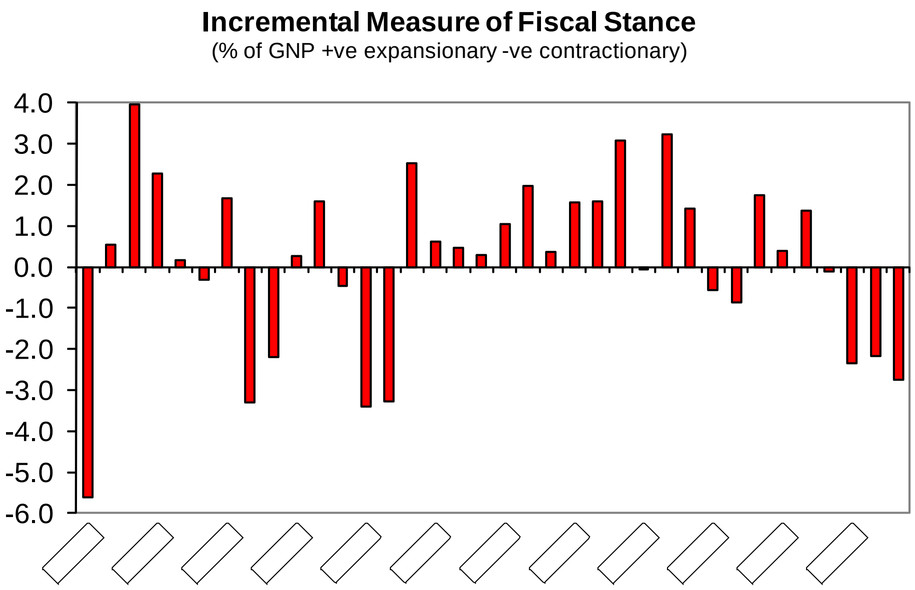
The Failure of Fiscal Policy

The other area of institutional failure was fiscal policy. From at least 2003 fiscal policy should have been progressively tightened (Lane, 2010). This would have reduced inflationary pressures in the economy, especially in the building and construction sector. Outside EMU this policy role would have fallen to monetary policy. However, with monetary policy set to manage inflationary pressures throughout the EMU it was not appropriate for Ireland. Instead, within EMU this role of preventing property bubbles from occurring must fall to fiscal policy (Conefrey and FitzGerald, 2010).

While a general tightening of fiscal policy was essential, its impact on the housing and property sector could have been made much more effective if specific measures had been taken which were targeted at that sector. FitzGerald, 2001 and Barry and FitzGerald, 2001 suggested the introduction of a tax on mortgage interest payments which would have had the same effect for households as a rise in interest rates. In 2003 the UK Treasury suggested a similar approach if the UK were to join EMU (Treasury, 2003). Instead of taking action to discourage investment in the property market in Ireland, the government introduced significant new tax incentives for such investment, alongside existing tax deductibility of mortgage interest payments.

In addition to using fiscal policy to manage the housing market, the government should also have also adapted its programme of public investment in infrastructure to fit within the capacity of the economy to deliver (FitzGerald *et al.*, 2003 and FitzGerald and Morgenroth, 2006).

Figure 4: Fiscal Policy Stance



Instead of tightening fiscal policy, throughout the period 2001-7 fiscal policy was generally very stimulatory. As shown in Figure 4, six out of eight budgets pumped more spending power into an already overheated economy. Also the tax system positively encouraged investment in property rather than discouraging it. A significant part of the stimulus was the overambitious nature of the public investment programme.

While policy makers can with some validity claim that their slumbers on the job of regulating the financial system were not disturbed by many outside noises, this is not true about the failure to manage the housing market. As far back as 2000, publications by the ESRI documented the concerns of researchers in the ESRI and elsewhere about the need under EMU for governments to use fiscal policy to prevent property market bubbles occurring.

Over the last twenty years each of the ESRI's *Medium-Term Reviews* has considered the medium-term outlook for the economy and the appropriate stance of fiscal policy. The introduction to each *Review* has referred to some relevant story from classical Greek mythology. The 2003 *Review* began with the story of Icarus! That publication identified the unduly expansionary fiscal policy, and the failure to control the housing market as a serious concern. The warnings became increasingly emphatic in 2005 and 2006 and this advice was picked up and widely reported in the Irish media.

There were many factors behind the failure to heed Cassandra's warnings over the 2001-7 period. After a decade of generally high growth and low unemployment there was a growing feeling among households and companies that the Irish economy was invincible – many people did not want to hear the message and consider the possible remedies.[4] For those in the financial sector and the building sector the prospect of profits today clouded their judgement (Nyberg, 2011).

However, there was a more general problem that the traditional understanding of the role of fiscal policy was no longer central to public discourse on economic policy. Much attention focused on the Stability and Growth Pact (SGP). However, as discussed above, the SGP was not the appropriate policy target for Ireland and Spain. In a sense, the SGP proved part of the problem rather than part of the solution.

Compliance with the SGP also discouraged international institutions from looking at the facts rather than the letter of the law. Because Spain and Ireland largely complied with the SGP, the EU Commission generally did not complain about reckless behaviour in managing their economies.[5] In both cases reliance on the simplistic official rules applied to these two economies suggested compliance with the SGP. As a result, other member states as well as the domestic populations of those economies received no early warning of impending dangers from the EU Commission or the IMF (O'Leary, 2010). This failure by outside assessors to warn of future dangers for the Irish economy has been highlighted in the reports into the origins of the recent policy failure (Regling and Watson, 2010, and the Honohan, 2010).

The role of the Department of Finance has been considered by a number of reports. Wright, 2011 says that the Department gave evidence that it issued verbal warnings to the government about the dangers but nothing was put on paper because of the need to disclose this information under the Freedom of Information Act. That report does show that warnings were given on paper about the excessive growth in public expenditure, but not about the inappropriate stance of fiscal policy. More recently, the Nyberg report shows that when outside warnings were issued about the dangers of fiscal policy the Department of Finance advised that the warnings were overblown. [6]

The failure of the Department of Finance to advise strongly about the dangers facing the Irish economy is surprising. In the past the role of civil servants was to advise the Minister on the best course of action and then to implement government policy. This advice was always provided in writing with a paper trail showing the development of Departmental thinking. The fact that the Oireachtas (parliament) legislated for freedom of information did not absolve civil servants from the duty to offer appropriate advice. If, as a result of the

[4] That people did not want to face up to the economic reality was evident in the discourse in the 2007 General Election, where both the government and opposition parties talked of a continuing boom.

[5] The EU Commission did raise concerns in 2001before the dangers became acute, but it did not follow up on this warning in subsequent years.

[6] For example, Nyberg, 2011, says: "The briefing for the Minister on the ESRI Spring 2007 QEC referred to the QEC's speculation regarding a housing bubble but advised that a soft landing was the most likely outcome."

legislation that advice was to eventually become public and the government did not like it, it was always open to the government to change that legislation.

The suggestion in the Wright report that the legislation was at fault in discouraging good departmental advice seems to target the wrong problem. Many of the reports on the genesis of the crisis comment on the pressures towards consensus. If the Department of Finance had offered contrary advice (which there is little evidence of) and it had become public after government decisions were made (as provided for in legislation) that would have contributed to the necessary debate.

Lurking behind the weak response of the Department of Finance was a culture that discouraged undue emphasis on economics. The tradition until now has been that for civil servants to progress through the ranks they need to be generalists not specialists. At least until now one could not have a career specialising in economics (or accountancy or law) within the Irish public service. While the Department of Finance had some very well respected economists on their staff working as economists, they were too few in number. The fact that being too specialised in economics would damage future career prospects sent out all the wrong signals. With the top echelons of the Department having reached their position through not being specialised economists it is not surprising that the policy advice on fiscal policy at a crucial period was, at best, weak.

It is a wider question for political scientists and historians as to why policy makers chose to ignore the warning signs in relation to property. Action to control the property market would undoubtedly have been unpopular. In particular, there was a continuing refrain that taxing mortgage interest payments would be unthinkable.

Many non-economists expect economists to produce palatable medicine. When unpalatable medicine is first prescribed it is automatically rejected. In the 1980s it took many years for reality to sink in and for enough painful medicine to be taken to deal with the economic crisis of that decade. The concern this time round for economists and policy makers is both about preparing the right prescription for the Irish economy as well as communicating the need for the unpleasant medicine to a very unhappy patient.

4. Institutional Reform

There are many lessons to be learned from this crisis, lessons for Ireland and lessons for other EU members. These include the appropriate role of fiscal policy for a member of a monetary union; lessons on how to manage the public sector, especially public investment in infrastructure; and lessons to be learned on how to improve public administration, some of which are pointed to by the Wright report (Wright, 2011).

As argued above, the most consistent sign that dangerous things were happening in individual national economies within the EMU was the deterioration in the balance of payments in Ireland, Spain, Portugal and Greece. Future EU monitoring should pay more attention to this key indicator. The revised SGP does not do this but the wider remit accorded to the EU Commission begins to address this problem. The problem with this latter

(EU Commission) role is that, for political reasons, very explicit targeting of the balance of payments is ruled out. This is because Germany, with a large surplus, fears being pressured to reduce this surplus through changing fiscal policy.[7]

In managing national economies within EMU fiscal policy has an even more important role than is the case in countries operating an independent monetary policy. In countries in EMU, in addition to managing domestic demand, fiscal policy is the key policy instrument to prevent domestic imbalances becoming acute; for example preventing asset market bubbles (especially in housing) from causing major damage.

The experience of Ireland over the last decade is that fiscal policy failed in its assigned role, allowing the housing market to get out of control and inflict massive damage in the economy. The Wright report does not provide any strong evidence that the importance of this role was recognised in the Department of Finance during the crucial period 2003-7, when action might have prevented the current crisis.

The capacity of the Department of Finance needs to be strengthened so that it can offer good policy advice in the future. In this regard there is a need to recognise that specialist expertise is needed to operate a modern public administration. This need for expertise goes beyond the need for economists to cover those with a wide range of other specialisations such as accountancy, law and banking. Until the Irish public administration is restructured to encourage the continuous development of such expertise over individual careers there will be a danger that policy advice may not be as well founded as it could be. Certainly there is an urgent need to recognise that economic specialists have important insights in how to manage modern economies.

In its recent discussion paper the Department of Finance set out a series of proposals for reform (Department of Finance, 2011). One of these proposals is to establish a Budget Advisory Council. The establishment of such an advisory body was suggested in Lane, 2010. However, the suggested terms of reference in the executive summary of the Department of Finance discussion paper does not include a mandate to advise on fiscal policy. However, in the detailed discussion in the document such a role is allowed for. If a Budget Advisory Council is to be able to prevent future mistakes like those of the last decade the role of providing advice on fiscal policy must be accorded centrality.

There is a series of fiscal rules proposed for enactment. While this is the approach favoured by the German government, it is not clear how well this approach will work in Ireland. It is arguable that the SGP was part of Ireland's problem over the last decade. The rules were not appropriate and they provided a crutch for bad policy-making. The lesson to be drawn is that no rules would probably be better than inappropriate rules. All rules should be considered for their economic logic and robustness before being implemented.

[7] Such a prescription would, in any event, probably be inappropriate as the Germany economy and the German labour market, while very slow to change, will eventually adjust to redress the imbalance.

As a result of the current crisis all of the attention on rules in the document is focused on designing fiscal policy so as to put the public finances on a sustainable path. However, once the current crisis is eventually over fiscal policy will also have a crucial role in managing the economy in the future. As argued above, it is the key instrument available to government to prevent future bubbles in the economy. It is also the appropriate instrument available to government to manage inflation in the non-tradable sector to restore and maintain full employment. This more “normal” role of fiscal policy, which appears in standard text books, is not clearly identified in the objectives set out in Department’s current paper.

In the 1990s, because so much of the funding for public investment in infrastructure came from the EU, Ireland was required to develop a sophisticated system of evaluation which provided evidence on which to base decisions on prioritising investment. Because there was still some residual EU funding in 2003, there was still some research work then being undertaken to underpin policy decisions (FitzGerald et al. 2003). However, the “if I have it I spend it” philosophy[8] meant that evidence for good policy making was no longer felt to be necessary for the future. This was very clear in the preparation of the National Development Plan for the period 2007-13.[9] For fiscal policy to operate effectively in the coming decade there must be a return to evidence based policy making and, of course, to the generation of that evidence through research.

While progress had been made over the last fifteen years in moving to a multi-annual budgetary process, which encouraged efficient and effective expenditure decisions, the current crisis changed this arrangement. The need to bring about immediate cuts and to control very tightly the budgetary outcome for the current year saw a return to a command and control approach by the Department of Finance since 2008. The issue of how to reconcile current pressures with more strategic planning in the future needs to be addressed.

Irish government accounts are exceptionally difficult to understand. This lack of transparency arises from the piecemeal way that the accounting system has developed over a long period. The EU accounting overlay provides a much more transparent link between what is happening on the ground and what is happening to the economy as a whole. The accounting framework needs major reform to improve transparency. In addition, a move to accruals accounting, as has happened in many other developed economies, would aid understanding and aid decision making.

The final area where dramatic changes are clearly needed is in the area of banking regulation. This issue is being tackled by major reform and restructuring of the Central Bank, integrating the previously separate regulator. However, in the longer term there is a strong

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[8] This was the stated policy of the then Minister for Finance in the early years of the last decade.

[9] FitzGerald and Morgenroth, 2006

argument for developing European regulation to regulate a European banking system. Such a European banking system could prove beneficial for Ireland in the longer term.

5. Conclusions

The current crisis in Ireland reflects domestic policy failures: major mistakes were made in fiscal policy and in banking regulation. For the future, governments in EMU, including the Irish government, need to pay more attention to the balance of payments as a warning signal of future dangers. However, the experience of policy failure in Ireland also suggests the need for institutional change. While much attention within EMU is being paid to new fiscal rules, the best safeguard against a repetition of past mistakes in Ireland is domestic institutional reform, both reforming regulation of the financial system and strengthening oversight of domestic fiscal policy.

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