

Banks, the State and Finance 1998-2007

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It is worth considering some of the other elements involved in a 'good bank' other than simply a strong asset base. Because if all we do is restore AIB and BOI to their positions before the crisis, then we do not necessarily get 'good banks' that will support economic development.

Let's take a look at bank lending in the ten years since capital gains tax was cut to 20% in 1998. This measure was followed by an increase of 466% in lending by financial institutions from 1998 to 2007, a significant contribution to the booming economy that followed that brought Ireland to one of the highest investment rates in the OECD.

However, as Table 1 shows, the vast bulk of these monies went into the property sector with construction, real estate development and housing finance accounting for the vast bulk of the increase and of the total lending by 2007. In contrast, the high profile high tech sectors don't get a look in. Despite rapid increases from a very low base in lending for R&D, lending to computer services firms remained a tiny proportion of lending and lending to hardware firms declined, as did the industry. The effect of the tax cut was to increase speculative lending in real estate and finance relative to the productive long term investments needed in high tech sectors, which remained a tiny proportion of Irish investment.

*Table 1: Financial Institution Lending (Resident non-Government) 1998-2007:
Selected Sectors*

<i>Sector</i>	<i>2007 percentage of total lending</i>	<i>1998 percentage of total lending</i>	<i>Percentage increase in lending 1998-2007</i>	<i>Percentage of the lending increase 1998-2007 that is accounted for by this sector</i>
Agriculture and Forestry	1.3	4.3	72	0.7
Manufacturing	2.2	6.1	105	1.4
Computers and office machinery (also included in manufacturing)	0.0001	0.0008	-3.5	-0.00001
Construction	7.0	2.4	1538	8.0
Financial Intermediation	16.2	28.3	224	13.6
Real estate activities	20.9	4.7	2417	24.4
Computer and related activities	0.05	0.06	389	0.05
Research and development	0.02	0.006	1928	0.03
Education (Schools and Colleges)	0.2	0.1	714	0.2
Health and Social Work	0.7	0.3	1105	0.7
Other Community, Social & personal Services	0.8	1.0	313	0.8
Personal House mortgage finance	33.6	29.6	542	34.5
Other Personal housing finance ²	0.3	0.7	161	0.2
Personal Finance for investment	1.6	1.3	593	1.7
Other Personal	5.0	7.4	283	4.5

The effects of this pattern of lending show up in investment over the period (see Table 2). While overall investment grew as a percentage of the economy, this increase was entirely driven by housing and investment in machinery and other non-housing investment declined as a percentage of GDP (and remained relatively flat in absolute terms). It is clear that capital gains tax rate reductions drove speculation and financialisation and not development. While capital sloshed around, Irish banks did little to guide it toward the kinds of investments that would have supported medium

and long term development.

Table 2: Gross Fixed Capital Formation as a % of GDP, 1980-2006.

	1980	1987	1994	1998	2006
<i>Total Investment</i>	27	16.1	16.3	21.7	26.3
<i>Housing Investment</i>	5.9	4.2	5	7.2	14.6
<i>Total Non-Housing Investment</i>	21.1	11.9	11.3	14.5	11.7
<i>Including: machinery</i>	6.2	7.3	4.5

Source: OECD Statistics

In fact, the agencies of the state were more successful in this regard. Under the Seed and Venture Capital measure of the EU Operational Programme 1994-1999, Enterprise Ireland committed €44 million to venture capital – just over a third of a total VC investment during the period of €129 million. 72% of that investment was in Dublin and 70% in software (Enterprise Ireland, 2007).

The importance of the state in providing financing and in stimulating private investment is indicated in Table 3 which provides data on private equity investments between 1997 and 1999, the period when private, increasingly international, investment took off in Ireland. These investments are concentrated in computer related sectors, electronics, ‘other manufacturing’ and (in 1999) communications. The Irish share of European private equity investment increased from 0.3% in 1995 to 0.8% in 1998 and 1.2% in 1999.

Table 3: Trends in Private Equity Investment 1997-1999 (000s of Irish pounds)

	1997	1998	1999
<i>Total Funds</i>	27,713	163,626	316,232
<i>Total State Funds</i>	10,048	20,775	12,151
<i>Selected Major Types of Investors</i>			
<i>Government</i>	36.3%	12.7%	3.8%
<i>Private Individuals</i>	13.7%	26.2%	21.7%
<i>Banks</i>	17.1%	3.7%	25.0%

<i>Pension Funds</i>	7.3%	8.2%	26.8%
<i>Geographic Breakdown of Private Equity Raised</i>			
<i>% Domestic</i>	100%	44.7%	42.8%
<i>% Other European</i>	0%	35.7%	19.6%
<i>% Other Non-European</i>	0%	25.2%	32.0%

Source: European Venture Capital Association, Annual Reports

In 1997 all investment was from domestic sources and one third of that was from the state. A significant portion of the remaining investment was stimulated by the state through ‘matching funds’ arrangements - perhaps up to an additional 25%. In 1998 domestic investment increased but more importantly international investors flooded into the increasingly successful Irish economy. The primary source of funds was private individuals as institutions such as pension funds, banks and insurance funds lagged behind. In 1999 however, institutional investors finally took the lead in funding. Non-European sources accounted for fully one third of funds in 1999, up from a quarter in 1998.

By 1999 Ireland was well integrated into international institutional investment circles and the state withdrew from its previously dominant role as a source of funds. However, individual and institutional investors largely followed rather than lead the growth of the high tech industries in which most of this funding was concentrated. Ironically, the risk taker here was the state. After the dot.com bubble burst in 2001, the state was crucial to the continuation and recovery of the venture capital sector.

Table 4: Venure Capital Investment in Ireland, 2000-2005

	Total Venture Capital €m	Enterprise Ireland Venture Capital €m	Enterprise Ireland Funds as % of total venture capital
2000	111.6	13.2	11.8%
2001	37.6	41.9	111.4%*
2002	27.4	20.8	75.9%
2003	32.9	14.5	44.1%
2004	27.8	16.2	58.3%
2005	36.1	8.1	22.4%
Total	273.4	114.7	42.0%

Source for Total VC: Félix, 2007

Source for EI Venture Capital: Enterprise Ireland Annual Reports

* Note: The 2001 statistics suggest that Enterprise Ireland provided over 100% of all venture capital invested that year. It is likely that there will be discrepancies among these different data sources, particularly arising from any lags in the disbursement of Enterprise Ireland monies to venture capital funds, and from those funds to client companies. Nonetheless the general trends and orders of magnitude should hold.

Table 4 shows that the bursting of the dot.com bubble was followed in 2001-2 with a drying up of almost all except the publicly provided funds and the continuing prominence of public funds in the recovery of venture capital investment as the decade went on. Given that much of the EI investment continues to be provided through mechanisms that encourage matched private investment, the majority of VC funding is publicly provided or stimulated, even if privately administered through a series of funds.

The public sector has been crucial to the provision of funds for investment in high tech and innovation, even as it competed with the rush of money to property and financial speculation induced by the tax decisions of its own government and administered by the banks that contributed relatively little to development.