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# The Crisis of Financialisation in Ireland

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*Abstract:* This paper explores the intersection of national and transnational processes in shaping Ireland's financial crisis. It uses insights from economic sociology to reconcile the analytical tension between an understanding of Ireland's crisis in terms of the unfolding of an international process and explanations that focus on specific national features. A series of significant policy decisions in the late 1990s favoured financial markets in allocating capital and opened up significant institutional space for speculative lending. Underneath the apparently consistent expansion of the property lending bubble since the mid-1990s, there was a significant shift in investment logics from the early 2000s as both residential and commercial real estate spending became detached from underlying demand. This shift in logic was based on two significant "translations" of investment rationalities into justifications of lending and investment that underpinned the bubble. Irish banks' own conceptions of risk and rational investments shifted subtly over time so that property lending was translated into a rational investment, encouraged by market dynamics such as increased bank profits, rising share prices and concentration of decision making power in the banking system. At the same time, and in the context of the establishment of the euro, investing in the assets of Irish banks was translated into a rational investment for international banks, in large part through the metrics of the credit ratings agencies. The paper concludes by revisiting the question of how we should understand the specifics of particular financial crises in conjunction with the general dynamics of financialisation – pointing to the importance of "translation" processes in creating social rationalities and the significance of "market liberalism" as a social formation in enabling these translations and promoting financialisation.

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## I INTRODUCTION

Ireland's economic crisis is most fundamentally a financial crisis, originating in a credit and asset bubble that toppled the banking system and brought with it fiscal, economic and social crisis. That crisis was not only built on a credit bubble greater than in most other economies but it reached further and deeper into the Irish economy than elsewhere. The export boom of the 1990s was damaged by the credit bubble which attracted financing that may well have supported industrial development, shaped student decisions to move towards qualifications that were rewarded in the property bubble, and inflated the cost base. Even more significantly, the financial bubble was incorporated into government finances and drove a fiscal crisis – first, through the increasing reliance in the 2000s on "bubble taxes" such as capital gains and property sales taxes and, second, through taking the losses of banks onto the public debt in 2008 and afterwards. Even as the crisis progressed, uncertainty about the scale of Irish bank losses inflated Irish bond yields. The Irish financial crisis was at the heart of the broader "five part crisis" (NESC, 2008) of Irish economy and society.

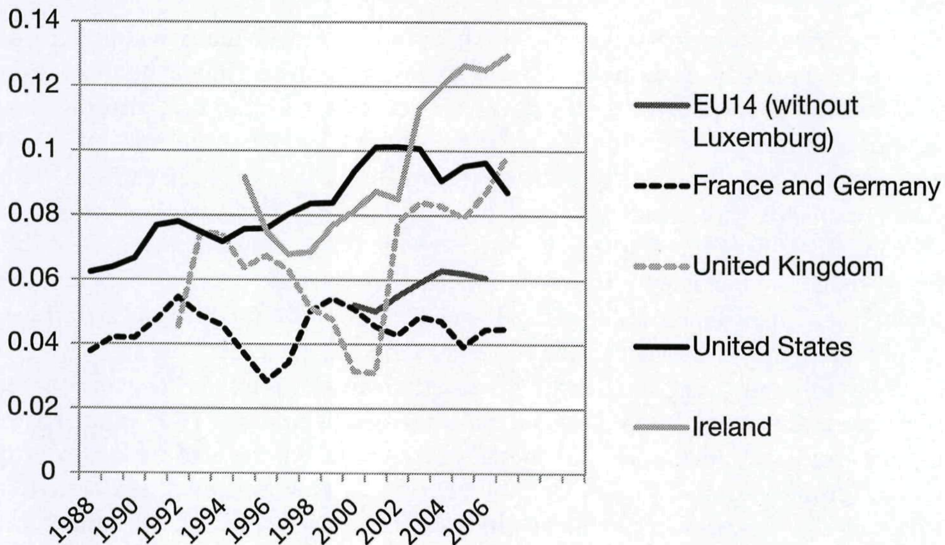
On one reading, Ireland's financial crisis was a very local crisis. The sub-prime mortgages and securitised mortgage products that were central to the triggering of the US crisis were much less important in the Irish case, where lending to developers and inflated property prices were much more significant (Connor, Flavin and Kelly, 2010). While mortgage lending practices loosened in the 2000s the crisis was not caused by mortgage defaults (although these became significant elements of the evolving crisis).

However, other features of the Irish crisis were shared more broadly. As Connor, Flavin and Kelly (2010) point out, Ireland shared with the US features such as "irrational exuberance" among market actors, a "capital bonanza" (easy access to cheap capital for banks – in the Irish case through international borrowing), and failures of regulation and "moral hazard". In addition, the various crises of the current period are linked through increasingly close financial integration, with the US crisis in 2008 the tipping point for Irish banks' collapse as inter-bank liquidity dried up very rapidly. This financial integration itself was closely linked to a broader project of economic liberalisation in recent decades.

Ireland proved a world leader in the financialisation of the economy: "the increasing role of financial motives, markets, actors and institutions in the operation of the domestic and international economies" (Epstein, 2005, p. 3). While there are many potential indicators of this process, Krippner (2011) takes the share of profits within the economy going to financial activities as her central measure of financialisation, arguing that this measure reflects

both the sectoral growth of finance and the accumulation of power within the economy. Figure 1 outlines trends in the profits of the "financial intermediation" sector (banks and other financial institutions, but not including insurance, real estate and other business services) for the years for which OECD statistics are available.

Figure 1: *Proportion of all Corporate Profits (Gross Operating Surplus) Going to the "Financial Intermediation' (Banking) Sector, 1988-2007*




*Source:* OECD STAN Database.
*Note:* EU14 and the France and Germany measures are an average of national rates, not a total of all profits across those countries.

The statistics reveal some interesting variation in Irish banking profits. Despite their lack of contribution to economic development (Honohan, 2006) Irish banks were comparatively profitable in the mid-1990s. Their share of corporate profits declined during the mid-1990s only to recover somewhat alongside the export boom of the late 1990s. However, Irish bank profits surged dramatically from 2003 to 2007. Ireland's financial expansion was, however, only one leg of a "triple financialisation", also including Anglo-American financial systems and the financialisation associated with European integration and the euro in the 2000s. While the US was always more financialised than the European core, that gap widened significantly over the 1990s, and financialisation is most closely associated with "liberal market economies" (Hall and Soskice, 2001) such as the US, UK and Ireland.

However, the EU economies closed the gap somewhat from 2001 onwards – with France and Germany showing a small surge in the 2002-2004 period although generally remaining significantly less financialised than the liberal economies. Analysis later in the paper shows that the German banking system was highly segmented, with internationalisation and trading of financial instruments strongly concentrated among the commercial banking sector. Since the proportion of Irish banks' liabilities derived from foreign sources grew dramatically in the 2000s (Lane, 2011), these were very significant trends.

The Irish financial crisis has both distinctive and more widely shared elements therefore. It is both a national and a trans-national phenomenon. The division of responsibility for the crisis between national and international factors is a matter of not only academic interest but profound disagreement and controversy in shaping policy responses, particularly in Europe. This paper explores this intersection of national and transnational processes in shaping Ireland's financial crisis. In order to do so, we seek to use insights from economic sociology to reconcile the analytical tension between an understanding of Ireland's crisis in terms of the unfolding of an international process and explanations that focus on specific national features.

The following section outlines an analytical approach that seeks to combine macro- and micro-sociological analyses of finance. In Section III we review the basic parameters of the Irish financial bubble and its apparently steady growth from the mid-1990s onwards. In this section I argue that a series of significant policy decisions in the late 1990s weakened the capacity of government to shape investment decisions and capital allocation. Given the absence of a banking system that provided significant patient capital or business lending, this opened up significant institutional space for more speculative lending. Sections IV, V and VI examine the evolution of the process of financialisation in Ireland and the formation of the credit bubble. First, the paper argues that underneath the apparently consistent expansion of the property lending bubble since the mid-1990s there was a significant shift in investment logics from the early 2000s as both residential and commercial real estate spending became detached from underlying demand. Second, the paper then examines how this shift in logic was based on two significant "translations" of investment rationalities into justifications of lending and investment that underpinned the bubble. Irish banks' own conceptions of risk and rational investments shifted subtly over time so that property lending was translated into a rational investment, encouraged by market dynamics such as increased bank profits, rising share prices and concentration of decision making power in the banking system. At the same time, and in the context of the establishment of the euro, investing in the assets of Irish banks was

translated into a rational investment for international banks, in large part through the metrics of the credit ratings agencies. Section VII concludes by revisiting the question of how we should understand the specifics of particular financial crises in conjunction with the general dynamics of financialisation – pointing to the importance of "translation" processes in creating social rationalities and the significance of "market liberalism" as a social formation in enabling these translations and promoting financialisation.

## II UNDERSTANDING FINANCIALISATION

Connor *et al.* (2010) draw attention to the tension between universal and specific features of financial crises. They contrast Reinhart and Rogoff's (2011) analysis of the universal features of financial crises with their own focus on the specific features of the Irish credit bubble, linked in particular to issues of governance and national business culture. These factors, they argue, are intrinsically context-specific whereas the market dynamics that are the focus of Reinhart and Rogoff's analysis are more generalisable. Market dynamics operate at a universal level of analysis but are mediated by national organisational and political cultures.

There is a similar split in sociological analyses of finance in the macro-economy and of social action by financial actors and in financial markets. The first strand tends to emphasise relatively consistent and widespread patterns of the expansion (and contraction) of finance in the economy. For some, historical surges in the importance of finance arise from the search of a declining economic and political hegemonic power for new sources of wealth and dominance (Arrighi and Silver, 2000). In the current era, the financialisation of the US economy since the economic crises of the 1970s and stagnant real incomes in the following decades is the classic case of such a process (Krippner, 2011). For others, financialisation is linked to the emergence of new technologies and, more broadly, new techno-economic paradigms, as capital rushes to gain the exceptional returns from the commericalisation of new technologies – most recently in the dot.com bubble and bust of the late 1990s and early 2000s (Perez, 2002). Most generally, Polanyi (1944) linked the rise of finance in the economy to a more general process of the rise of market society, where markets came to dominate the social structures within which they were embedded.

While the macro-sociological literature on financialisation emphasises the ebb and flow of finance over time, the second strand in social studies of finance explores the micro-conditions or "social structures of finance" (McKenzie, 2006). While patterns of capital allocation are produced by many individual

investment decisions, these decisions themselves prove to be rooted in broader investment communities, with shared notions of value, risk and rationality in the market. Increasing attention is being paid to the dynamics of financial markets, including research on behavioural finance in economics and in sociology on how participants in financial markets contest and dispute the fairness and dependability of prices and the standardisation of financial instruments (McKenzie, 2006, 2012). These studies have yielded insight into the cognitive and interactional foundations of financial markets, but have relatively little to say about how such markets vary from context to context, or how they connect to broader processes of financialisation.

How are these universal and specific features of crises linked? To understand this we need to break down the separation between universal market processes and context-specific social and political processes. Action in financial markets is shaped by the social and political contexts within which those markets are embedded. Where we observe broader patterns of the expansion of finance in the economy this must be linked in turn to the expansion of contexts that enhance the role of finance in economic life. Particular social contexts create the conditions that make "financial action" more likely. The specific forms this takes may vary even as the conditions for the increased importance of finance spread. As these various forms of action emerge and are institutionalised, together they form the macro-trends that come to be seen as "financialisation".

Carruthers and Stinchcombe (1999) develop the useful concept of a "social structure of liquidity" as a way of understanding how such processes of action and interaction are linked to the social structures within which they are embedded. This is a bold attempt on their part as they seek to show the "embeddedness" of among the most marketised forms of economic organisation – highly liquid settings where assets can be disposed without significantly transforming the structure of markets and pricing. Social structures of liquidity consist of a set of actors including buyers, sellers and intermediaries and, crucially, a set of instruments that actors agree are easily tradeable.

Carruthers and Stinchcombe take as one of their cases the very securitisation of mortgages that later proved so central to the US financial crisis. Theoretically, they emphasise the importance of liquidity as a problem in the sociology of knowledge, where it is critical to explain how market actors come to have a shared belief in the reliability and value of tradeable assets – whether those are mortgage backed securities, futures and options, shares in high-tech companies, commercial property development loans, or other assets. Indeed, any kind of social action depends on an interpretation of future conditions – and the possibility of this interpretation depends upon the future being "solid enough" to permit a degree of planning and rationalist delibera-

tion and decision making. For Stinchcombe, "... the social structures and processes that make parts of the future solid enough to plan on are, ordinarily, what we usually call institutions, and the process of creating solidity to the future is what we usually call institutionalisation" (1997, p. 391).

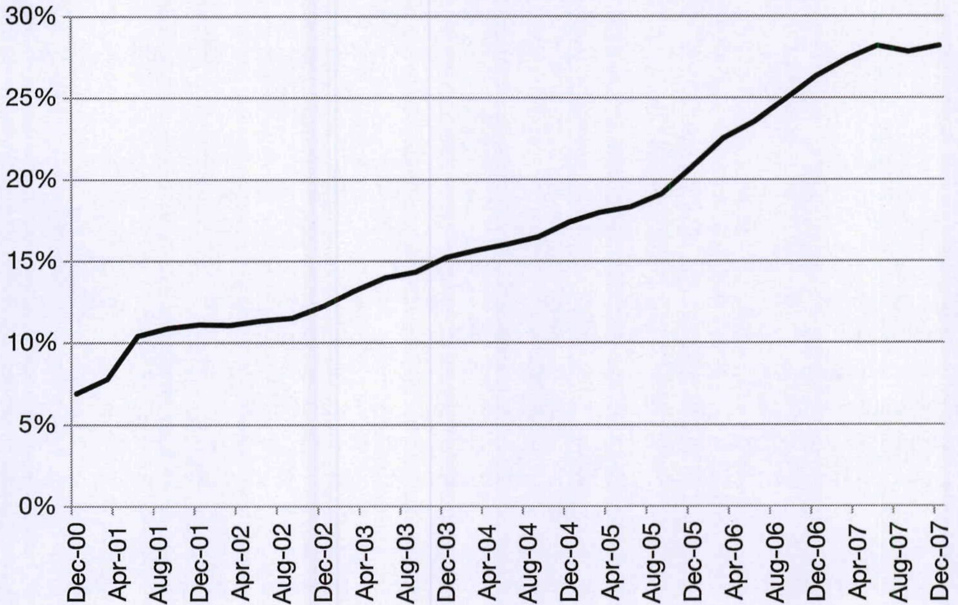
The concept of "social structures of liquidity" deserves a fuller treatment but it directs our attention to a number of key points. First, any liquid asset depends upon a shared set of definitions of value and tradeability, definitions which are themselves somewhat illiquid in that they are rooted in specific institutions, sets of buyers and sellers and national, occupational and other cultures (McKenzie, 2012). Financialisation both transforms national economies and business cultures, but also works through and is mediated by them. Second, as "liquid" finance seeks out investment opportunities it links together multiple "social structures of liquidity" – which may in turn compete, interact and reinforce or undermine one other. Third, this linking process involves important elements of "translation" of the varying definitions of what are sensible investment opportunities – with the growth of institutions and organisations whose function is largely to provide this translation, including in particular the growth of "markets for governance" (Davis, 2011) and certification, regulation and arbitration by private agencies (Sassen, 2006). The rest of this paper explores how such processes shaped financialisation in the Irish context.

## III IRELAND'S PROPERTY AND LENDING BUBBLE

As is well known, the dynamic of economic growth in Ireland shifted firmly from an export-led expansion of employment and domestic demand in the 1990s to an economy fuelled by domestic consumption and, particularly, construction in the 2000s. Over the 2000s, the growth strategy increasingly took the form of a "growth machine" where land-based elites "... profit through the increasing intensification of the land use of the area in which its members hold a common interest .... Governmental authority, at the local and nonlocal levels, is utilised to assist in achieving this growth at the expense of competing localities" (Molotch, 1976). The long-established connections between property developers and political elites were significant in reinforcing this model of growth. However, where past incarnations of the growth machine had relied heavily on state funding (through social housing expansion in the 1930s and through state office expansion in the 1970s), the property growth machine of the 2000s was linked to a booming private market in residential and commercial property.

Ireland's boom in the 1990s almost inevitably included elements of "overheating" and even "irrational exuberance". However, the damaging effects of such tendencies were likely to be weakened as long as they were balanced by the marshalling of newly available resources for productive purposes. In the decade after the reduction of capital gains tax to 20 per cent in 1998, these resources expanded as bank lending in the economy grew 466 per cent. However, 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. Despite rapid increases from a very low base, lending to R&D and computer services firms remained a tiny proportion of overall lending and lending to hardware firms declined, as did the industry. Construction and real estate lending increased from 7 per cent to 28 per cent of total lending over the period (Figure 2). In contrast, the high profile high-tech sectors attracted less than 2.5 per cent of credit[1] (Ó Riain, 2009).

Figure 2: *Percentage of Total Credit Going to Construction and Real Estate Activities, 2000-2007*

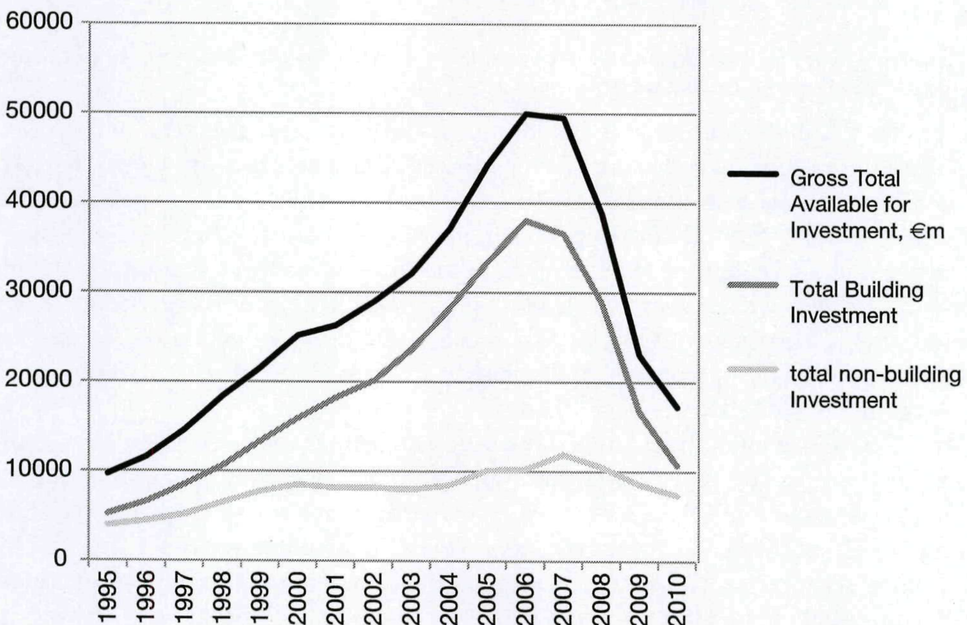



*Note:* These figures do not include personal mortgage lending.
*Source:* Central Bank of Ireland, multiple years, *Sectoral Distribution of Credit.*

[1] Data on lending from Central Bank of Ireland, multiple years, *Sectoral Distribution of Credit.*

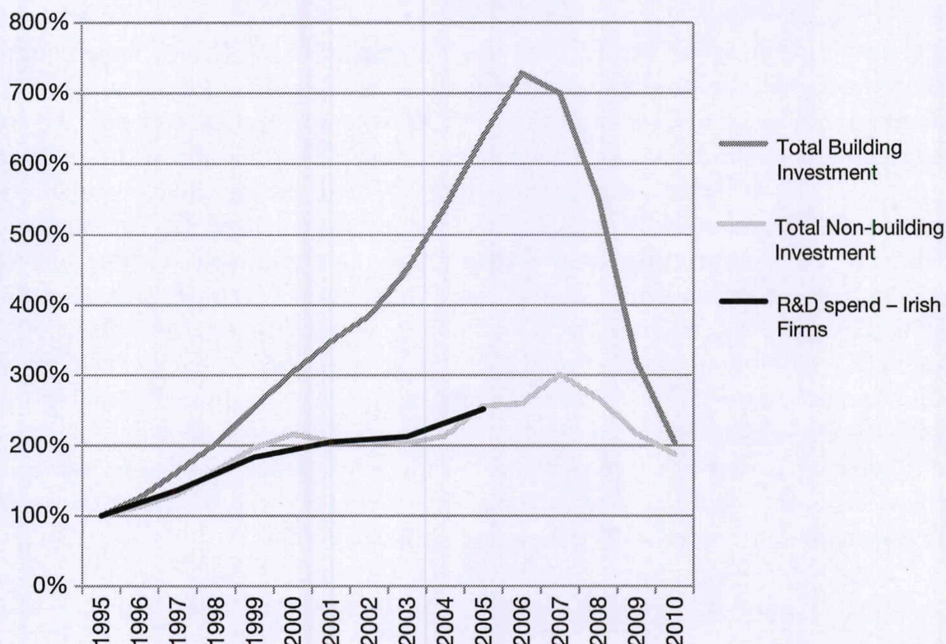
Figure 3 shows in absolute terms how, although non-construction investment increased, the vast bulk of the capital available for investment in the economy went into construction. The growth in construction investment was large in the 1990s but further sped up in the 2000s. It may be of course that the figure for productive investment is understated as "non-material" investments become more important (e.g. R&D, marketing, and so on). Figure 4 provides some information on this, as well as a clearer picture of the relative growth of the different forms of investment. Non-building investment grows substantially, and steadily until 2007. The relative growth of R&D spending of Irish-owned firms is also plotted in this graph, as an indicator of the kinds of productive investments made in non-material factors of production during this time. For the years where data is available in a consistent series (1995-2005) the R&D investment tracks the non-building investment trends very closely. Construction investment of course increases much more quickly until 2006, with the same even more rapid increase from 2003 onwards showing up in the data on relative growth rates. In short, while the construction boom began in the 1990s, the dominance of construction over other productive forms of investment was dramatically consolidated in the 2000s.

Figure 3: *Capital Availability and Investment, 1995-2010*




*Source:* CSO, *National Income and Expenditure Annual Results 2011.*

Figure 4: *Relative Growth of Different Forms of Capital Investment, 1995-2010*




*Source:* CSO, *National Income and Expenditure Annual Results 2011*; Forfás (multiple years) *R&D in the Business Sector.*

This bubble was rooted in changing national and investment politics. The Fianna Fáil – Progressive Democrat coalition government elected in 1997 combined a longstanding "growth machine" approach of the populist FF dynasty with the liberalising economic policies of the PDs. In the new government's budget of 1998, capital gains tax was reduced from 40 per cent to 20 per cent with a view to releasing pent up capital into the economy. As we have seen, this goal was rapidly achieved – but that capital flowed primarily and rapidly into property investment. It also shifted the dynamics of investment politics.

Transnational corporations have been the primary source of private sector investment in Ireland. In addition to expanding production and employment, many of them used Ireland as a centre for transfer pricing and related financial activities. In many respects, this expansion in entrepôt activity in Ireland was the equivalent of the financialisation of non-financial corporations documented in the US by Krippner (2011, Chapter 2). Nonetheless, this was a negotiation with industrial capital whose dominance of investment in Ireland favoured production, at least from the perspective of the domestic economy.

In addition, the 1990s had seen the expansion of the capacity of state agencies in supporting and developing indigenous firms (Ó Riain, 2004; Girma *et al.*, 2008). The most successful firms benefited as much from public subsidies and supports as from private investor interest. Research into software firms in Ireland shows that a "developmental network state" boosted economic performance as those firms that received the most state grant aid exported more, employed more people and grew faster (Ó Riain, 2004). These positive effects of state aid have also been found in manufacturing companies in the 1990s (Girma *et al.*, 2009) and the 1980s (O'Malley *et al.*, 1992). The bulk of early financing of Irish companies came through state-sponsored investment schemes – it was only after growth was well underway in 1999 that private venture capital flooded into Ireland. In 1997, with the Celtic Tiger already roaring, over a third of private equity investment came from state sources and much of the private investment was stimulated by state incentives for investors (Ó Riain, 2004).

More generally, stockbroker Rossa White (White, 2010) has documented private sector failure to turn liquidity into investment in greater detail. He finds that from 2000 to 2008 investment in housing stock increased by 156 per cent. Productive capital investment increased by 66 per cent, or €70 billion However, of this €70 billion road building made up €13.5 billion, another €20 billion was invested in retail infrastructure (building shops, etc.), public buildings took up €9 billion and investment by semi-state companies and energy/ utilities companies took up a further €10 billion. Ultimately, in an era when bank lending increased by three to four times, inflation adjusted productive capital stock spend by private enterprise increased by 26 per cent between 2000 and 2008. Productive investment in Ireland has largely been driven by foreign private capital and domestic public funding and supports.

The weak historical role of banking in Irish development and the focus on property lending went so deep that banks' organisational capacities to lend in support of other sectors and, more generally, business development was weak. As one fund manager told me, "The skills of cash flow lending have been lost in Ireland, because people have been doing asset backed lending for so long". Indeed, this was significant enough that in late 2008 and 2009, the state industrial development agency Enterprise Ireland sent some of its business development officials to the major banks to advise them on commercial lending and business development – transferring business lending and development expertise from the public to the private sector (NESC, 2012).

However, the capacity for public action was weakened from the late 1990s. ICC, a profitable state-owned industrial investment bank, was sold and ultimately largely withdrew from business lending. The number of state

agencies involved in regulation grew rapidly during this period (Mac Carthaigh, 2012). However, for all their activity these regulatory agencies varied greatly in their power and effectiveness. While some agencies dominated their constituencies others were less immune to "capture". The Financial Regulator was designed as a relatively weak institution – in its official powers, its range of action and its personnel. The Regling-Watson report of 2010 details a series of additional failings in the regulatory system. To add to the difficulties of regulation, the state dealt with both finance and construction not only as regulator but also as promoter of industry growth.

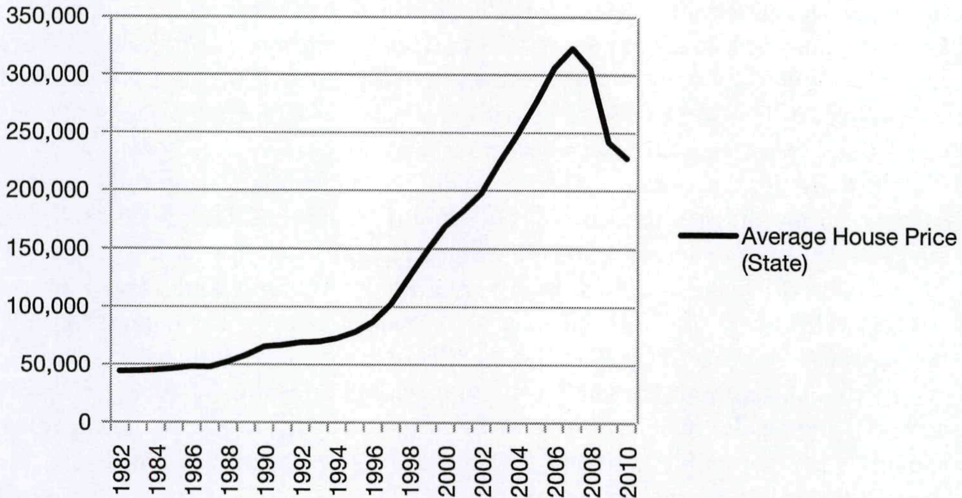
The financial sector was a target of industrial development, identified as a priority sector, with the main instrument for delivering this growth the International Financial Services Centre (IFSC) in Dublin. As one supporter wrote in *The Irish Times* in 2006, "In the early days the value proposition for the was simple: low corporation tax, a light touch regulatory regime – as little red tape as possible – and an English speaking workforce located in the EU. It was a value proposition that appealed to the international financial services community as attested to by the rapid growth of the IFSC." Others viewed the light regulation less benignly, describing the international reputation of the IFSC as part of the "wild west" of financial (de)regulation (O'Brien, 2006). With a weak regulator, little ability to steer long-term investment using taxes and the removal or marginalisation of public agencies shaping capital allocation, the field of domestic investment was ripe for banking dominance. With little historical role in productive investment and business development, a booming economy and a long standing property based "growth machine", the banking sector was never likely to resist investing in a property boom.

## IV SHIFTING LOGICS WITHIN THE PROPERTY BOOM

Figure 5 indicates that house prices began to rise rapidly in 1994-1995 and continued on a steep, almost linear trend until 2007. However, Whelan (2010) suggests that Irish house prices could be explained by rising incomes and changing demand linked to demographic and family change until at least 1997 – and possibly later if we take the low interest rates of the period into account. By 2007, however, Irish houses were overvalued by at least 30 per cent.

We can take a closer look at these shifting dynamics by examining the link between demand and supply in residential housing markets. Table 1 shows the correlations between the vacancy rate in dwellings (excluding holiday homes and uninhabitable buildings) at the time of the three censuses of the period (1996, 2002, 2006) and the percentage increase in new housing stock in

Figure 5: *House Prices in the Irish State, 1982-2010*




*Source:* Department of the Environment, *Housing Statistics.*

the following three years (April 1996-December 1999, April 2002-December 2005, April 2006-December 2009) (see also Kitchin *et al.*, 2010). Since a high vacancy rate implies a relatively low level of demand, we would expect that high vacancy rates (low demand) are negatively correlated with a high percentage of new housing stock (i.e. high supply). We are able to examine these relations by using data on vacancy rates and housing stock and completions in the 34 local authority areas in the state (including major urban areas and the 26 county areas).

Table 1: *Correlation Between Vacancy Rates and New Housing Stock in Local Authority Areas, 1996-2009*

| *Counties Included (N)* | *1996*1996-1999* | *2002*2002-2005* | *2006*2006-2009* |
|---|---|---|---|
| All areas (34) | –0.32 | 0.14 | 0.36 |
| Non-USRS (29) | –0.23 | 0.04 | –0.09 |
| Urban and Environs (15)* | –0.22 | 0.07 | –0.41 |
| Urban (8)** | –0.03 | 0.05 | –0.91 |

* City areas plus County areas attached to cities (e.g. Limerick County) and Wicklow, Kildare and Meath (surrounding Dublin).
** City areas only.
*Source:* Data provided by All-Ireland Research Observatory, NIRSA, NUI Maynooth. Thanks to Rob Kitchin and Justin Gleason.

The top line provides the results for all areas. The second line provides the results for all counties except the five counties of the Upper Shannon Renewal Scheme (USRS). This scheme started in 1998 and provided generous incentives for investment in property in the declining rural counties of Cavan, Leitrim, Longford, Roscommon and Sligo. These counties accounted for 5.1 per cent of completions in 1996-1999, 7.2 per cent in 2002-2005, and 9.8 per cent in 2006-2009. The last two lines provide the results for the city areas and their contiguous counties, and finally for the city areas alone.

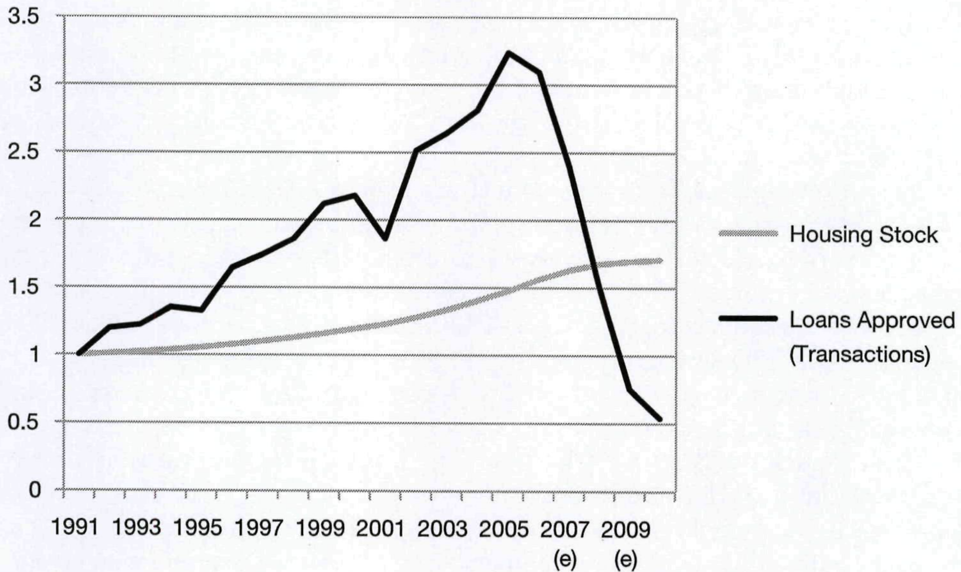
Care should be taken with the small numbers of cases in some of the categories but the results are nonetheless interesting. A negative correlation suggests that high vacancy rates depressed the increase in new housing stock in subsequent years – as common sense about demand and supply might suggest. However, the data suggest that overall supply of housing became increasingly delinked from demand, particularly between 2002 and 2005.

In the 1990s, high vacancy rates suppressed subsequent supply in most areas, although the relationship is weakest in the urban areas. All areas break the link with demand in the early 2000s, although the break is strongest in the five USRS counties (as shown in the gap between the correlation for all counties and for the non-USRS counties). In the period from 2006 onwards, supply in the USRS counties continue to go against demand, and rural areas in general remain largely delinked from demand (see the difference between non-USRS and Urban and Environs). Supply and demand are closely linked once again in urban areas.

Overall, the data suggest that a boom in the 1990s was only detached from demand in the urban areas, but that completions in the early 2000s were increasingly detached from demand across the country. This suggests a broadening boom that was turning into a widespread bubble. Of all ghost estates in 2010, 89 per cent (or those with dates assigned to them in the dataset) were granted planning permission in 2002-8 (based on analysis of data data provided by All Ireland Research Observatory (AIRO). The volume of transactions also increased during the 2000s (Figure 6), suggesting an increasingly "liquidity" of housing as an asset.

In the later 2000s the residential bubble weakens significantly, except for the tax incentive areas of the USRS. In the late 2000s, demand re-asserted itself as a factor in developers' logics in urban areas. However, they appear to have continued to search for opportunities in rural areas (most clearly in tax incentive areas but also much more broadly) even as developer behaviour in urban markets returned to some semblance of normality, albeit at highly inflated prices. Small local developers also appear to have helped drive this continuing expansion of construction in rural areas as local builders were tempted into moving into development.

Figure 6: *Volume of Transactions in the Housing Market (As Measured by Loan Approvals) and Housing Stock – Growth Relative to 1991 Base Year*




Taken together, these patterns suggest that a housing boom turned into a widespread housing bubble that was then aggravated by the property based tax incentives provided in certain areas. This is reflected also in trends in the granting of planning permissions that allow the construction of various buildings (Figure 7). Residential planning permissions grew strongly from 2002 to 2005, as the correlational analysis suggested, but then began to decline with an increase in extensions to existing homes. The residential market then seemed to cool somewhat from the mid-2000s.

No such cooling took place for commercial development with planning permissions increasing rapidly until 2007. Whereas residential planning permissions in 2007 were 17 per cent higher than 2001, commercial planning permissions were 132 per cent higher. Figure 8 traces the evolution of the office construction market in Dublin from 1991 to 2011, the largest market for non-residential development.[2] The market shifted significantly over these decades in a number of significant ways – including massive expansion and suburbanisation (McLaran, 2012). However, our focus is once more on the link between demand and supply and the shifting logics of developers over time.

[2] The data were kindly provided by Andrew MacLaran, TCD. There is an analysis of broader trends in Dublin commercial real estate in MacLaran *et al.* (2012).

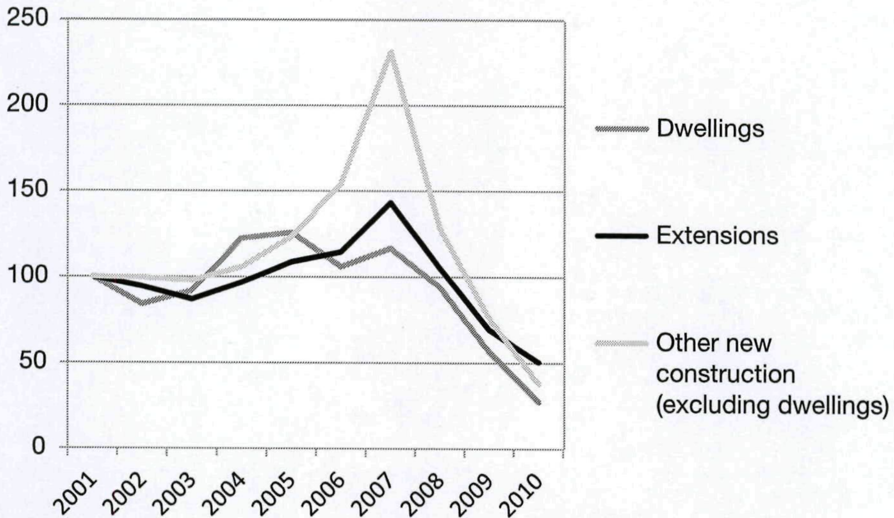
Figure 8 shows the percentage of office space in any given year that was newly added since the previous year. It shows that between 1995 and 2001 there were significant increases in the proportion of new office space added each year, reaching a peak of 12.6 per cent in 2001. The rate of increase dropped rapidly in the downturn of the following two years but then increased again to remain between 5 and 6 per cent between 2006 and 2009. This suggests that a major bubble in the late 1990s was followed by a smaller bubble in the mid- to late-2000s.

However, a closer look at the underlying logic of demand and supply across the period reveals a quite different picture. As in residential construction, we can track how closely vacancy rates affected office space supply (i.e. how responsive developers were to demand) by looking at the relationship between office vacancy rates in a given year (demand) and the percentage of new office space in the following year (supply). Figure 9 plots the percentage of new housing stock in a given year on the y-axis, with the vacancy rate in the previous year on the x-axis.

In the early 1990s, the market was stagnant with vacancy rates around 10 per cent, but growth through the 1990s soon took off – with the percentage of new office space climbing steadily each year. What is striking, however, is that vacancy rates fell during the same period as underlying demand was strong. A sudden spike in development in 2000-2001, combined with a stuttering economy, lead the vacancy rate to spike and this increase in vacancy rates continued as the economy struggled from 2001 to 2003. However, it is striking that, after a spike in the area available for rent in 2001, the rate of supply of new office space reduced rapidly. However, from 2004 to 2008 the supply of office space increased again to an additional 5-6 per cent per year. At a time when there was a great deal of office space vacant in Dublin, development activity continued at a level that maintained and even increased those vacancy rates.

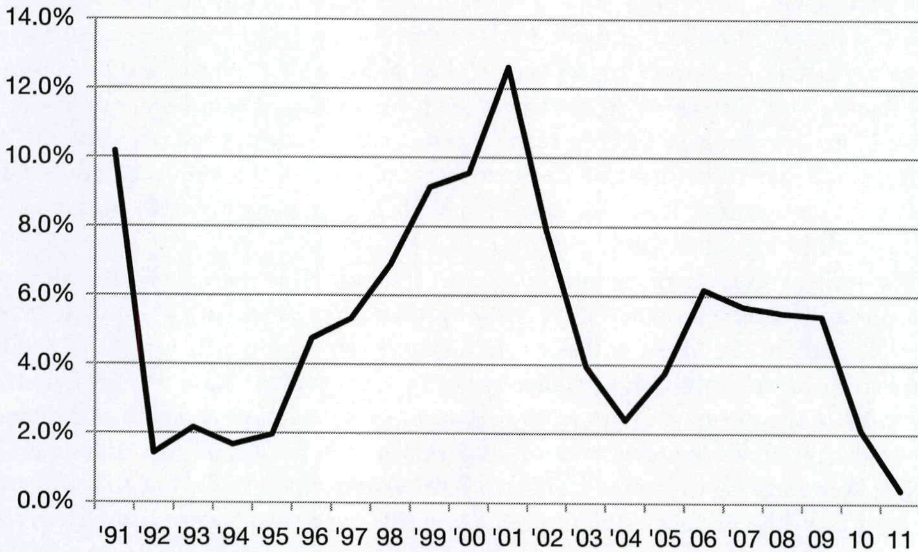
The time horizons of property deals were shortened as developers at the height of the boom were building housing estates that had already been sold off the plans, or where urban renewal and other development tax incentives had greatly reduced the financial risks involved. The practice of "flipping" properties – building properties that were sold to investors for more or less immediate resale to other buyers became quite widespread (Kelly, 2010; MacDonald and Sheridan, 2009). In addition, first person accounts suggest that developers were increasingly tied into the bubble through interlocking deals and interests, making it difficult for them to exit the complex network of contracts that sustained the highly leveraged market (Kelly, 2010). A whole range of actors were tied into the dynamics of the bubble through booming land values, housing and office space prices and rent, and property flipping (Kitchin *et al.*, 2010).

Figure 7: *Rate of Change of Planning Permissions Granted 2001-2010 (2001=100)*



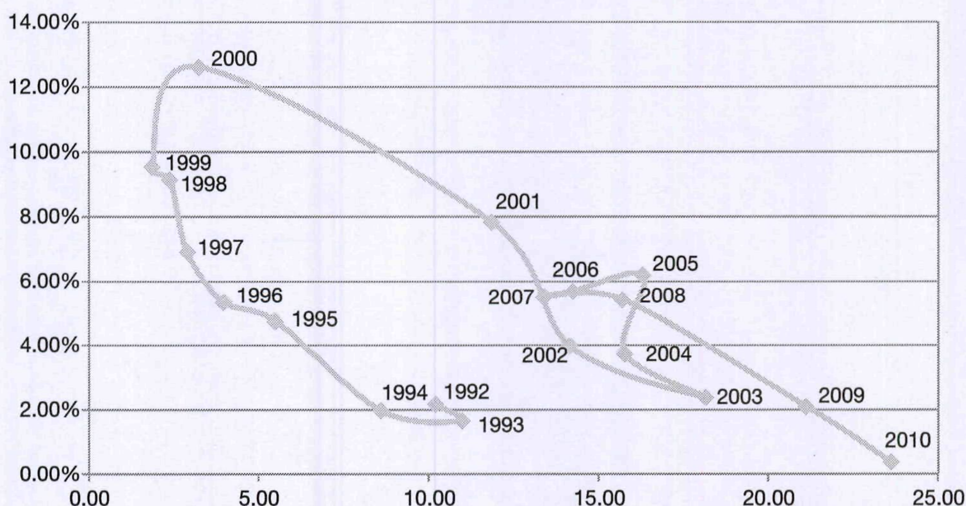

*Source:* Department of the Environment, *Housing Statistics*.

Figure 8: *Percentage of Office Space Added in the Previous Year, Greater Dublin Area, 1991-2011*




*Source:* Data generously provided by Andrew MacLaran, TCD. Further details in MacLaran *et al.* (2012).

Figure 9: *Office Space Vacancy Rate and New Housing Stock in Subsequent Year, Dublin 1991-2011*



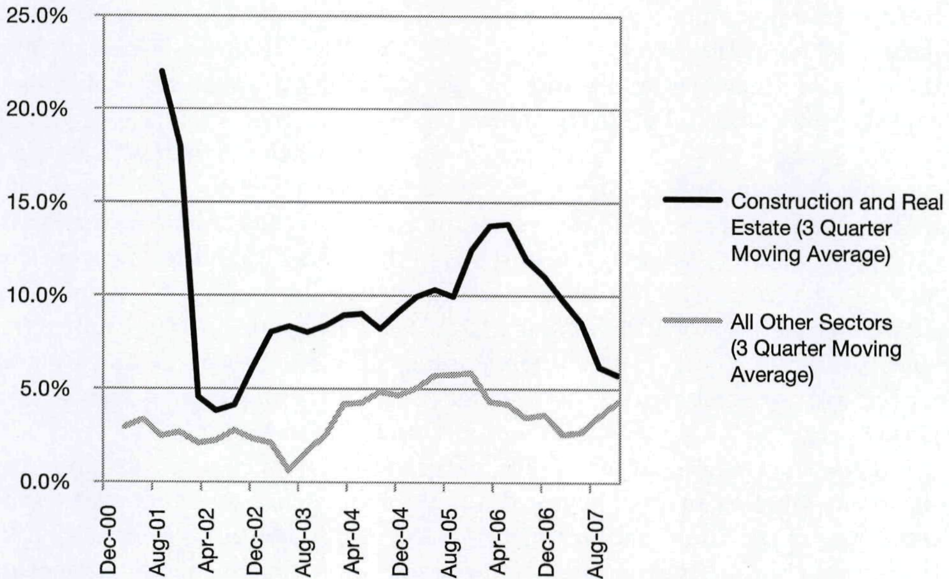

*Source:* Data provided by Andrew MacLaran, TCD. Further details in MacLaran *et al.* (2012).

In short, the property market moved from a highly liquid market in property development assets to a market in real estate development liquidity itself – in the "flipping" of deals with relatively low levels of uncertainty over short periods of time. However, these short-term "solid futures" were increasingly built, as we soon discovered, on futures that were remarkably fragile in the medium to long term. While residential markets had begun to adjust somewhat before the downturn of 2007 and the crisis of 2008, the commercial market and the key firms within it continued to inflate the property bubble until the crisis hit.

Finally, we can turn to credit itself. Here again, it is instructive to examine the broadly linear pattern of increase in credit outlined in Figure 2 in more detail. Figure 10 indicates trends in the speed at which the volume of credit increased in the economy, measured on a quarterly basis (and reported as the average of the previous 3 quarters' increase). It shows that the rate of increase of credit provided for construction and real estate activities ran ahead of all other sectors at all times from 2000 to 2007. Across the middle of the boom, the rate of increase in development credit and all other credit went broadly in the same direction. However, there are also interesting variations. In the period from early 2002 to mid-2003 (the bursting of the dot-com bubble) credit to non-development sectors grew slowly and barely at all in the first half of 2003.

However, real estate development credit grew rapidly. Again in 2005-2006, property and construction related credit in the economy grew increasingly rapidly even as the rest of the economy saw a slowing of credit growth.

Figure 10: *Quarterly Percentage Increase of Credit to (a) Construction and Real Estate Activities (b) All Other Sectors (3 Quarter Moving Average of Quarterly Increases)*




*Source:* Central Bank of Ireland, multiple years, *Sectoral Distribution of Credit*.

The origins of the property and credit bubbles lie in the late 1990s, when economic growth was driven primarily by exports and by an increase in domestic demand (including, but not limited to, housing). Construction and real estate investment and lending grew faster than the rest of the economy, even during this period. However, during this period investment in both housing and commercial real estate largely tracked the increasing demand and declined in 2002-2003 as the economy slowed. However, from that period on, while the rest of the economy was much slower to recover, property lending and investment expanded very rapidly and became increasingly detached from demand. Buyers and sellers chased the market in an increasing volume of sales while credit grew rapidly – most of the long-term damage to the economy was done in a relatively short number of years between 2002 and 2008, even if the conditions for a bubble have been put in place before the 2000s.

## V TRANSLATION OVER TIME: PROPERTY LENDING BECOMES MORE RATIONAL

How did the developers and banks themselves make sense of this bubble ? Looking at the construction sector, the press releases from four major companies identify almost no risks until 2008. McInerney, a major residential builder, suggested in 2005 that "Strong market demand for Irish housing shows no sign of diminishing. It is expected that this demand will continue, boosted by employment, demographics and inward migration. We remain well positioned to capitalise on these trends". Treasury Holdings reported from their 2007 annual conference that "… the sun is not ready to set on Ireland's rapidly growing global property empire".

While there was some recognition of slowing growth and market pressures in late 2007 and 2008, these risks were discounted based on "… a very strong indigenous economy and a strengthening international environment" (Treasury, 2007); "ongoing strength in the non-residential construction market" (Kingspan, 2008) and a "… resilient income producing portfolio and its well timed long-term development pipeline" (Shelbourne, 2008). McInerney observed in 2007 that "… the fundamentals of the Irish economy and housing market remain strong although consumer caution became more evident as the period progressed, impacted by the tightening of interest rates".

Banks' optimistic assessments of asset quality, capital position and economic growth also evolved over time – becoming more confident even as the conditions of the banking boom became less sustainable. Here it is instructive to examine the annual reports of the banks and the risks and mitigating factors they identify in their Chairman's and introductory statements.

Table 2 classifies the major business issues mentioned in the opening statements of the annual reports of the three major banks from 2000 to 2007. Although there are broad similarities between the banks, there are also interesting differences. The retail focus of the Bank of Ireland is evident in its focus on operational efficiencies and weak focus on capital and risk management. What is not clear from the table is the lack of detailed content in the reports of Anglo Irish Bank and the general and formulaic character of many of the statements. The issues raised are considered in more detail in the reports of the other two banks.

In a 2006 issue of *About Banking*, the journal of the Irish Banking Federation, two solicitors argued that Ireland needed to prepare for the end of the bubble by securitising more asset classes so it was poised to take advantage of the recovery. Similar articles in trade magazines and the national press also interpreted the crisis in terms of the US difficulties with subprime mortgages and securitisation and minimised the possibilities of

Table 2: *Key Business Issues – Years Mentioned in Bank Annual Report Opening Statements, 2000-2007 (8 years)*

| | *Risk Management* | *Capital Position* | *Asset Quality* | *Operational Efficiencies* | *Market Position* |
|---|---|---|---|---|---|
| Anglo | 3 | 3 | 5 | 0 | 2 |
| AIB | 6 | 4 | 5 | 4 | 4 |
| BOI | 2 | 1 | 6 | 6 | 2 |

contagion from the US and the importance of commercial rather than residential property lending to Irish banks.

The first element is the concept of *economic or market fundamentals* – underlying aspects of the economy which allow the discounting of specific or localised risks. This concept extended across a range of institutional actors, often used in quite similar ways. This allowed the discounting of warning signs in the economy through the bubble period:

- "Economic fundamentals remain firm – demographics, job creation, income growth and the government's fiscal position all remain positive while the interest rate outlook is now more supportive. These fundamentals support ongoing demand for housing, although below the exceptional levels seen in recent years. Buyer and seller expectations are realigning and prices are likely to settle with a measured reduction in supply. This will support a more stable house price environment, important to the long-term growth and competitiveness of the Irish economy" (Anglo Annual Report, 2007).
- "While short-term economic prospects for AIB's main markets are somewhat mixed, the medium term outlook is more positive. Irish GDP is forecast to slow to 2.5 per cent this year, reflecting the slowdown in the housing sector and a weaker global economy. However, economic fundamentals remain solid and growth is expected to pick up again in 2009 and beyond." (AIB Annual Report, 2007.)

A second dimension is the reliance on the *self-correcting* properties of the market, obviating the need for extensive political management of economic tensions:

- "After a decade of such strong price growth it was always inevitable that the market would peak and that prices might start to come back at some stage" (*About Banking*, 2007).

- "New Dublin office supply in the next two years will be very modest as output has been reduced significantly in the last 12 months, helping the market move towards equilibrium .... House prices have been falling in Ireland now for 19 months, longer than in many other countries, and this, combined with falls in interest rates, means that Irish housing is now significantly more affordable than it has been for some years and in 2009 is expected to drop to 1997 affordability levels. (*Source:* AIB Economic Research)." (Treasury, 2008).
- "The set of circumstances that could result in a sudden sharp correction to the market are not in place and it is unlikely that they would come into place for the forecastable future" (Friends First, 2006).

These came together in the varying trends in each bank's assessment of the macroeconomic environment. This proved crucial as many of the positive assessments of banks' asset quality and of sectoral trends are justified in terms of their underlying value and the percentage of performing loans – factors that were increasingly dependent upon, and justified by, ongoing economic growth. For example, the Danske bank chief argued in *About Banking* in 2006 that Ireland did not have a bubble because of the presence of low interest rates, financial innovation and liberalisation that was still reducing the cost of borrowing, and the trend towards urbanisation driving high end demand as elites desired city centre living.

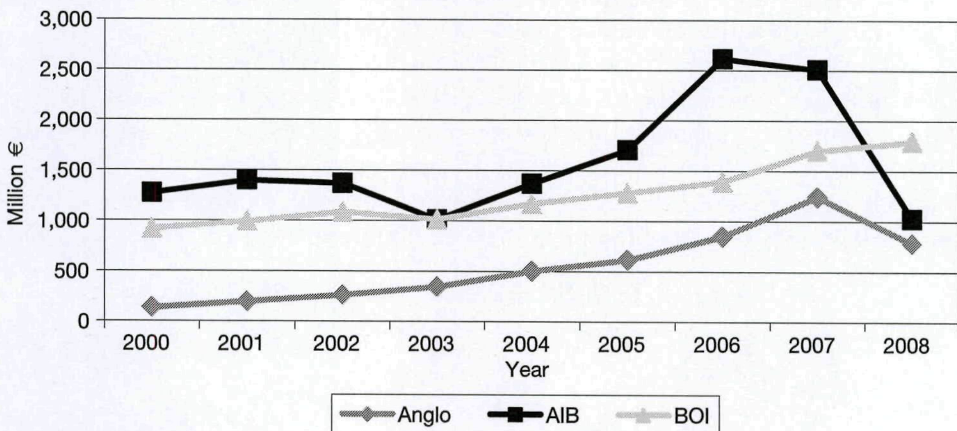
Table 3 examines trends in macroeconomic assessments more formally. Anglo Irish Bank's reports indicate some concerns in 2000 but throughout the 2000s are almost exclusively positive in their assessment – and particularly at the height of the bubble in 2005-2007. By contrast, in the uncertain years of 2001-2003 AIB's evaluations were negative while Bank of Ireland's were mixed. However, these concerns disappeared at the height of the boom with all three banks offering uniformly positive assessments. As the bubble grew, the banks that had expressed concerns in the earlier years converged on Anglo's lack of concern about the bubble.

Competition between the banks appears to have been a factor in "crowding in" the two leading banks, AIB and Bank of Ireland, into property lending. Figure 11 shows trends in profits among the "Big 3" banks in Ireland and the surge in Anglo's profits, to the point where it had significantly closed the gap with Bank of Ireland by 2007. Executive compensation followed suit – including, as became apparent in 2008, secret loans to executives and directors of as much as €70 million. AIB in particular responded with a shift into real estate and development lending, with a corresponding surge in profits and subsequent collapse.

Table 3: *Assessments of Macroeconomic Environment – Positive and Negative Mentions in Bank Annual Report Opening Statements, 2000-2007 (8 years)*

| | *2000* | *2001* | *2002* | *2003* | *2004* | *2005* | *2006* | *2007* |
|---|---|---|---|---|---|---|---|---|
| Anglo | | | | | | | | |
| Positive | | X | X | | | X | X | X |
| Negative | X | | | | | | | |
| AIB | | | | | | | | |
| Positive | | | | | | X | X | X |
| Negative | | X | X | | X | | | X |
| BOI | | | | | | | | |
| Positive | X | X | X | | X | | X | X |
| Negative | | X | X | X | | | | |

Figure 11: *Bank Profits, 2000-2008*




*Source:* Annual Reports.

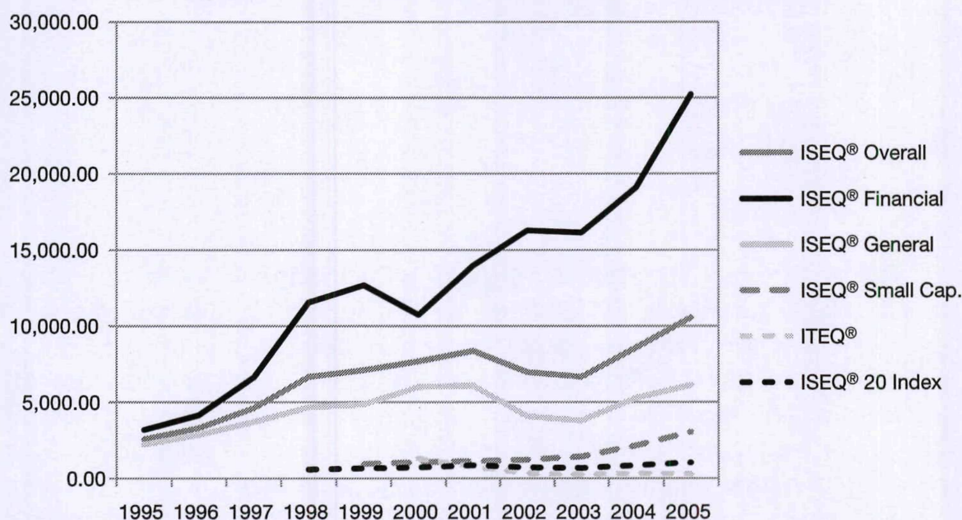
If market competition could not provide the discipline required, perhaps managerial authority could. In practice, however, the centralisation of executive authority in the banks further reinforced the convergence of optimistic assessments of asset quality, capital position and economic growth. Bank executives faced few challenges to their perspectives. Authority within the banks was highly centralised, as the Anglo report of 2006 notes: "The Bank's centralised business model enables quick decision making, ensuring consistent delivery of service to our customers and effective management of risk. It also allows us to operate in an efficient and streamlined manner, as

reflected by our cost to income ratio of 27 per cent". Senior bank executive salaries rose rapidly in all banks through the 2000s, with bonuses that were in practice increased by corporate strategies that inflated the bubble (TASC, 2010).

Furthermore, bank executives, and especially key figures like Seán Fitzpatrick at Anglo and Laurence Crowley at AIB, were at the very centre of interlocking directorates in the Irish business world. Cement Roadstone had a Director on each of the banks' boards while Anglo had directors from McInerney and Dublin Docklands Development Authority, Bank of Ireland from the DDDA, and Irish Life and Permanent from Kingspan and the Grafton Group. In general, the most intensively networked executives were bank executives or property investors and developers (TASC, 2010, p. 10, Table 3). Internal centralisation of authority and close external networking of executives are likely to have minimised the opportunities for alternative perspectives to establish themselves and to have reinforced the property based social structure of liquidity. Relatively autonomous managers failed to provide the organisational mechanisms to ensure financial prudence.

Shareholders were the other candidates for providing sufficient external oversight from within the private sector as a "market for governance" (Davis, 2011). However, the stock market itself reinforced the tendencies towards financialisation. Figure 12 shows the progress of a variety of Irish Stock Market Indices from 1995 to 2005. The General Index showed strong growth in the late 1990s but dipped from 2001 to 2003 and only recovered by 2005.

Figure 12: *Irish Stock Market Indices, 1995-2005*




*Source:* Irish Stock Exchange, online indices.

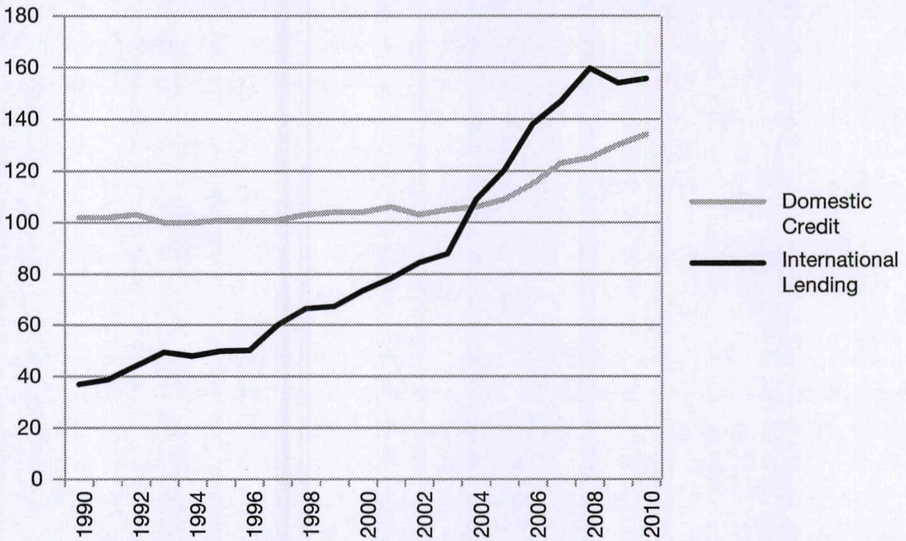
However, the financial stocks surged from 2000 onwards, after strong growth in the 1990s. The stock market was also a weak mechanism for distributing investment to the productive and innovative, rather than speculative, sectors. The technology-based index never recovered subsequent to the dot-com bubble bursting in 2001 while the financial stocks increased rapidly in value. The stock market rewarded the lending patterns that were summarised at the outset of this chapter.

## VI TRANSLATION OVER SPACE: LENDING TO IRISH BANKS BECOMES MORE RATIONAL

So far, our analysis has focused on domestic processes. However, a crucial element in the transformation of this property-based growth machine into an engine of national crisis was rapid increases in international lending to Irish banks through the 2000s. This facilitated the increase in the scale of activity through the 2000s that turned bank debt into a national catastrophe in 2008. While in 2003, 20 per cent of Irish banks' net liabilities were owed to international lenders, this rose to almost 80 per cent by early 2008 (Lane, 2011). Around one-third of Irish banks' international liabilities were in the eurozone, hovering above that from 2003 to 2006 and then trending slightly more towards the rest of the world – the US and particularly the UK – from 2006 until 2009. The bubble in property and finance in Ireland was primarily funded through UK, US and European lenders. Access to international lending broke any automatic limits that a national economy might place on credit bubbles within its own borders. The social structure of liquidity that underpinned the asset bubble was not only local but also transnational.

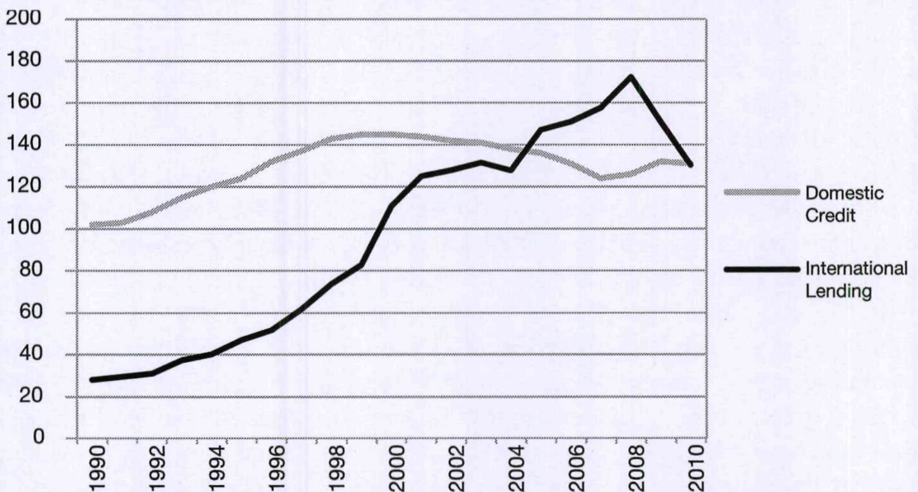
The Irish financial crisis was intertwined with this international financialisation and particularly with the increasing international reach of French and German banks in international financial markets. Figures 13 and 14 show that while domestic credit expanded in the French and German economies over the past two decades, it is the growth in international lending by domestic banks that is the most striking change in each financial system. In addition, while the changes in domestic credit vary between the two countries, the trends in international lending are strikingly similar. The loosening of credit in the German domestic economy was greatest in the 1990s, with recovery after unification, but slowed in the 2000s. In France, by contrast, the growth in domestic credit was in the 2000s and tracked the growth in international lending at the time. International lending by both financial systems went from below 40 per cent of GDP in 1990 to around 160 per cent at the peak of the 2000s credit boom. Together these represented a

Figure 13: *Domestic Credit in the French Economy and International Lending by French Banks, 1990-2010 (Percentage of GDP)*




*Source:* BIS Consolidated Banking Statistics, Table 9; World Bank, Financial Statistics.

Figure 14: *Domestic Credit in the German Economy and International Lending by German Banks, 1990-2010 (Percentage of GDP)*




*Source:* BIS Consolidated Banking Statistics, Table 9; World Bank, Financial Statistics.

massive expansion of credit – and an expansion that was concentrated increasingly in international operations.

Where did the international lending of French and German banks go? Table 4 shows the location of the foreign claims of banks from France, Germany, the UK and the US. The Irish statistics are provided for indicative purposes only as they include both lending to domestic banks and to the IFSC. These statistics only begin in the first quarter of 2005, understating the surge in international lending that began in earnest in the 1990s and grew dramatically from 2003/2004. The growth in international lending is much broader than the interaction with the European periphery, even though for German and French banks the SPIIG countries figure more prominently over time. Nonetheless, even among lending into SPIIG countries accounts for one-quarter of German and just under a quarter of French international lending at the peak of the credit boom. The international lending boom found an outlet in the European periphery (Figure 15), but it was not driven by developments in peripheral countries but by broader dynamics of financialisation.

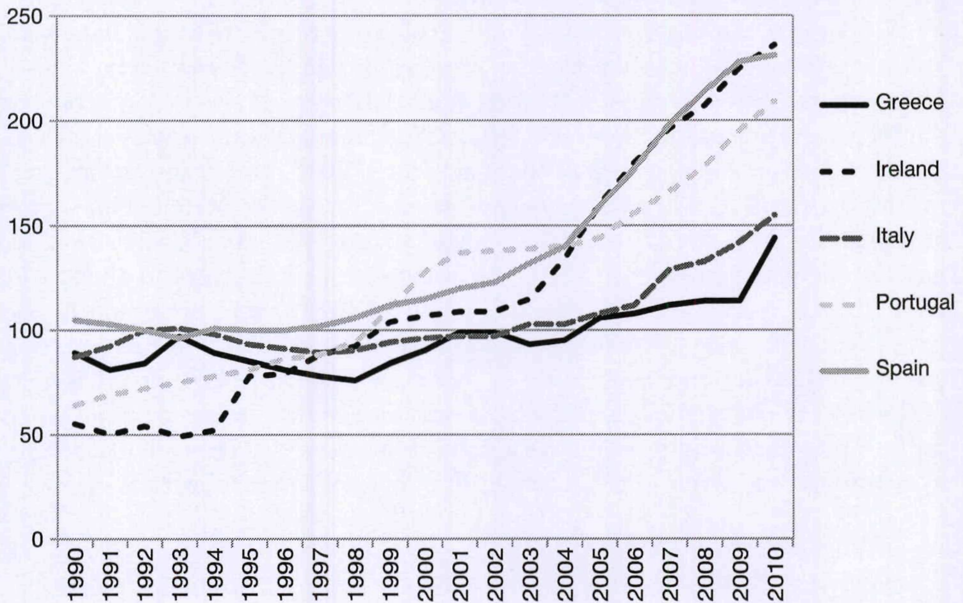
Table 4: *Foreign Claims of Domestically Owned Banks, 2005-2008: Proportion of Foreign Claims in European Periphery of German, French, UK and US Banks*

| | *Germany* % | | *France* % | | *UK* % | | *US* % | |
|---|---|---|---|---|---|---|---|---|
| Total Increase in International Lending 2005-2008 | 35.0 | | 127.1 | | 79.9 | | 63.3 | |
| | *2005 Q1* | *2008 Q3* | *2005 Q1* | *2008 Q3* | *2005 Q1* | *2008 Q3* | *2005 Q1* | *2008 Q3* |
| Ireland | 3.3 | 5.4 | 1.7 | 2.5 | 4.2 | 4.6 | 1.0 | 2.4 |
| Spain | 4.0 | 6.7 | 4.5 | 4.9 | 3.0 | 3.1 | 2.2 | 1.9 |
| Greece | 1.3 | 1.0 | 1.2 | 2.3 | 0.4 | 0.3 | 0.8 | 0.5 |
| Italy | 5.8 | 5.6 | 7.6 | 12.8 | 2.8 | 2.0 | 3.7 | 1.6 |
| Portugal | 1.0 | 1.1 | 0.9 | 0.9 | 0.6 | 0.6 | 0.3 | 0.2 |
| Total SPIIG | 15.3 | 19.8 | 15.9 | 23.4 | 11.0 | 10.6 | 8.0 | 6.6 |

*Source:* BIS Consolidated Banking Statistics, Table 9.
*Note:* The Irish statistics are provided for indicative purposes only as they include both lending to domestic banks and to the IFSC.

Not surprisingly, this overall increase in lending contributed substantially to a credit boom in the SPIIG countries in the 2000s. By 2007 domestic credit in these two economies was at 200 per cent of GDP, while it was 125 per cent of German and French GDP.

Figure 15: *Domestic Credit in the European Periphery (Percentage of GDP)*




*Source:* World Bank, *Financial Statistics.*

Ireland's story is a particularly dramatic national pattern of credit expansion, but this is embedded in a broader transformation in financial systems in the European core and periphery. The question then becomes how it was possible that the banking systems of core and periphery could become so enmeshed given historically weak relations and the apparent bubble character of their property booms in the 2000s.

A crucial role here was played by the credit rating agencies, private regulatory organisational forms that provide ratings of the quality of a wide variety of financial instruments, linked both to private and sovereign issuers. They offer a market in regulatory monitoring. They have also become crucial in creating the informational basis for markets in financial products and assets. The ratings provided by agencies are in many cases what is effectively being traded as the character of the underlying asset is of less value than the re-sale value of the asset and the possibility of re-packaging and/or securitising it (or part of it).

International lenders did not lend into specific loans or business development projects provided by Irish banks. Instead the funds were raised through various offerings of bonds, commercial paper and other instruments associated with the banks (Killian *et al.*, 2011, Appendix 4). Investors' decision

to invest in these instruments depended heavily on the rating of the funds and the banks. Although credit rating reports are largely proprietary, the press releases of Moodys ratings agency are publicly available on the corporate website. It is possible to obtain from these releases the major changes in Anglo Irish Bank's credit rating from 1998 to 2008 and to analyse the summary comments provided by Moodys, outlining the reasons for ratings changes (see Table 5).

Table 5: *Moody's Credit Rating Changes and Summary Comments Regarding Anglo Irish Bank, 1998-2008*

| *Date* | *Long Term Deposit Rating (LTD) Financial Strength (FS)* | *Comment* |
|---|---|---|
| Various, 1998-2001 | Baa1 (LTD)<br>D+ (FS)<br><br>Increase to:<br>A3<br>C | "In the context of 20 per cent banking growth rates in 1997/98, which is not sustainable longer term, a key challenge will be to preserve acceptable asset-quality indicators".<br>"The rating agency added that asset quality remained sound and that profitability has been reasonable, constrained in part by the costs associated with the bank's acquisitions."<br>"Anglo-Irish's credit quality is constrained by its reliance on middle market corporate lending. Furthermore, the bank is reliant on market funding and has a limited retail deposit base."<br>"Moody's has maintained a stable outlook on First Active's ratings, noting that the bank's financial condition was sound, even after the effects of margin compression, and that the mortgage and savings business offers predictable earnings with a lower risk of credit losses than many other sectors".<br>"Moody's added that the bank's profitability could be affected by an economic slowdown in Ireland but the agency sees this risk as manageable, short of a less likely 'hard landing'".<br>"Moody's added that the bank's profitability could be affected by an economic slowdown in Ireland". |
| *2002* | – | – |
| 2003 | Change from stable to positive outlook | "Loan-loss provisions are likely to increase in 2003, but underlying asset quality remains sound".<br>"Liquidity levels in the sector are good (underpinned by Central Bank requirements)".<br>"Moody's said the changes in the rating outlook |

Table 5: *Moody's Credit Rating Changes and Summary Comments regarding Anglo Irish Bank, 1998-2008 (Contd.)*

| *Date* | *Long Term Deposit Rating (LTD) Financial Strength (FS)* | *Comment* |
|---|---|---|
| | | reflected the continuing progress Anglo Irish has made in strengthening its funding profile despite strong lending growth, whilst maintaining the quality of the loan book".<br>"although the ratings agency expects that the weakening of property markets in the UK and Ireland will put pressure on profitability going forwards".<br>"Moody's notes that Irish banks have limited exposure to troubled sectors overseas such as high-tech, telecoms and aviation". |
| 2004<br>C+ | A2 | "The upgrade takes account of the AIBC's on-going success in maintaining and indeed growing its position within the highly competitive Irish and UK commercial property lending markets. Importantly this growth has not been at the expense of asset quality which remains good, built as it is on precise underwriting standards. In particular we note that AIBC's lending for investment property lending is on pre-let properties and that its exposure to larger high profile properties is limited. Further most loans are secured on a portfolio of property cashflows". |
| 2007 | A1<br>C+ | Re UK Covered bonds new issuance:<br>"The Cover Pool comprises a relatively concentrated pool of commercial mortgage loans. In particular, the borrower and property diversity is lower than for other Cover Pools. Moreover, properties securing the Mortgage Loans comprise of a significant portion of specialty and operating assets. These assets bear a relatively high operational risk resulting in relatively challenging servicing, especially in case of a Mortgage Loan's adverse performance or default. Moody's has taken property quality, property diversity and borrower diversity into account when determining the required over-collateralisation".<br>"The A2/P-1/C+ ratings of AIBC reflect the bank's stable market position and proven strategy as a secured lender to medium-sized corporates, professional property investors and high net worth individuals. The ratings also take into consideration |

Table 5: *Moody's Credit Rating Changes and Summary Comments regarding Anglo Irish Bank, 1998-2008 (Contd.)*

| *Date* | *Long Term Deposit Rating (LTD) Financial Strength (FS)* | *Comment* |
|---|---|---|
| | | AIBC's sound profitability, good credit quality and rigorous lending approach. AIBC is somewhat reliant on short-term wholesale funding, mitigated by the ongoing diversification of funding sources and by the institution's successful deposit-gathering strategy. Moody's noted that, whilst the issuance of extendible notes provided a further degree of diversification to the group's funding base, it nevertheless regards the instruments as a less robust form of long-term funding given their 13 month tenure". |
| 2008 (pre-guarantee) | A1 | Comments on rating of covered bonds issuance as Aaa "The Covered Bond investors benefit from<br>1) The credit strength of the Issuer, rated A1/Prime-1.<br>2) A pool of assets securing the Issuer's payment obligations under the terms of the Covered Bonds (the "Cover Pool"). The Cover Pool comprises of UK commercial mortgage loans that have been originated by the Issuer and has a weighted average LTV of approximately 75 per cent.<br>3) Securitisation style techniques designed to i) mitigate the risk associated with the possible deterioration of the credit profile of the Cover Pool; ii) ring fence the Cover Pool in the event of the insolvency of the Issuer; iii) mitigate the risks associated with the credit deterioration of the swap counterparties and of the Cover Pool; and iv) mitigate refinancing risk, through the extension features contemplated in the terms and conditions of the Covered Bonds.<br>As is the case with other covered bonds, Moody's considers the credit strength of the transaction to be linked to that of certain parties, mainly the Issuer in particular from a timeliness of payment perspective. Should such credit strength deteriorate, all other things being equal, the rating of the Covered Bonds may be expected to come under negative pressure. However, the Issuer has the ability, but not the obligation, to increase the over-collateralisation of the transaction in order to reduce the linkage to the credit strength of the Issuer". |

Anglo's credit rating climbs steadily through a period when the bubble was growing and then inflating rapidly. The comments in the years to 2003 exhibit a degree of caution that largely disappears in the later bubble years. In addition, the reasons for raising the credit rating are specifically those issues that came to be the downfall of Anglo – asset quality, poor underwriting and operations, cashflows from bubble operations, and securitisation. Not surprisingly, this gave reassurance to Anglo itself. They comment regarding similar upgrades by Fitch: "We are delighted that the Bank received yet another upgrade of its credit ratings, most recently in February this year by Fitch Ratings, the international rating agency. The Bank's long and short term ratings now stand at A and F1 respectively. This provides further evidence of the Bank's underlying strength and follows the upgrade last year by the international ratings agency Moody's, of the Bank's long-term deposit credit rating" (Annual Report, 2002).

Rather than monitoring the market, the rating agencies were firmly embedded within the rationalities of the property and credit bubble – in the process reproducing and deepening it. In the process, they "translated" the Irish banks' activities into a homogenised metric of asset quality that enabled international funders to purchase bonds issued by Irish banks. The agencies played a critical role in translating the specificities of the Irish social structure of liquidity around property into a set of defined, standardised instruments that could be traded alongside other instruments from other social structures of liquidity around the world.

It is worth noting briefly here that access to international funding was shaped by Ireland's integration into economies that were themselves financialising in distinctive ways. In particular, European banks had departed from their previous close ties to industrial firms, where German banks in particular served as "hausbanks" for leading industrial firms, providing long term "patient capital". Beyer and Hopner (2003) argue that the German model of corporate governance underwent very significant changes during the 1990s, as a variety of diverse small changes from the mid-1980s onwards coalesced into a significantly transformed overall regime by the late 1990s. These resulted in "... the increasing shareholder orientation of companies; the strategic reorientation of the big banks from the Hausbank paradigm to investment banking that resulted in a loosening or abandoning of ties with industrial companies; the withdrawal of the state from infrastructural sectors via privatisation; and the break of continuity in German company regulation that supported and accelerated shareholder orientation and network dissolution" (2003, p. 180).

As indicated in Figure 1 above, these banks watched US financial institutions' profits race ahead of their own through the 1990s. In the 2000s,

European banks involved themselves much more deeply in international financial markets. Between 2001 and 2008, the share of Deutsche Bank's assets that were international increased from 66 per cent to 82 per cent (Annual Reports). This was linked also to securitisation as IMF figures show a dramatic increase in German banks' use of securitisation, with issuance in 2006 that was over six times greater than levels in 2004 (IMF, 2009, p. 13). The ability to purchase "notes" issued by Irish banks, with high credit ratings attached, was attractive to European banks which were seeking assets that could be components in their own securitised financial instruments. The bubble in German banking may have been shorter and less dramatic than in the liberal economies. It was also concentrated among the commercial banks, with significant elements of the banking system – including the savings and state banks – remaining largely outside the bubble and continuing to lend to small businesses before and through the crisis (Federation of Small Businesses, 2012, p. 12). Nonetheless, German financialisation became enormously consequential for countries like Ireland. The triangle of Irish banks, international funders and credit ratings agencies connected the Irish social structure of liquidity based on personalised property development lending to the international trade in securitised financial instruments through the standardising effects of credit ratings. In the process, it weakened the ties between financial and industrial capital in both the European periphery and the core.

## VII CONCLUSION

The excessive and foolhardy lending to the property development sector in Ireland was produced by a number of social and institutional shifts. The property-based "growth machine", linking developers and political elites, especially in Fianna Fáil, has long been a feature of Irish society. However, it could only become the force that derailed the national economy through three crucial steps.

First, it sidelined alternative "social structures of liquidity" – most notably, the export oriented industries that had been the primary drivers of economic development in the 1990s. These sectors were dominated by foreign investment but were also shaped by public agencies supporting the development of indigenous firms (Ó Riain, 2004). Private banks were notably absent from the process of indigenous industrial and business development. When capital gains tax was cut and financial regulation weakened in the late 1990s, private capital was given the institutional power to decide the destination of investment and favoured property over technology (or indeed other potential productive industries, such as food).

Second, the banking sector itself came to see property lending as a rational investment strategy, despite warnings regarding the risks of a bubble. More specifically, the banking sector promoted property even after the slowdown in growth in the 2002-2003 period and as property development became detached from demand. Justifications for this support relied heavily on notions of strong economic fundamentals and self-correcting markets. Competition between banks "crowded in" the banks who were late to property lending into an enthusiastic pursuit of the profits enjoyed by Anglo Irish Bank and others. Neither managerial authority nor markets for governance through the stock market provided the necessary check on this risky activity. Instead, property lending was translated over time into a rational investment.

Third, the expansion of this activity to a scale that was disastrous in terms of the national economy was dependent on the willingness of international lenders to fund Irish banks. This occurred most dramatically between 2002 and 2007 and was encouraged by the liberalisation and internationalisation of significant sections of German and French banking and the financial integration associated with the euro. However, the specific ties between international and Irish banking were made possible by the translation over space of Irish lending into an internationally tradeable asset through the work of credit rating agencies.

These steps together linked the general process of financialisation and the specific features that characterised it in Ireland. The existence of a broader process of financialisation facilitated its expansion in Ireland. However, that broader process itself is constituted out of the interaction of a variety of national systems of finance – for example, the early financialisation of the US encouraged banks in Europe to pursue strategies based on trading in international financial markets in place of patient lending to domestic business, which in turn enabled the expansion of Irish property lending.

The Irish case also shows the importance of market liberalism as a force promoting financialisation of the economy. In Ireland, this had three major dimensions. The first dimension was the *institutional power of capital markets*, as legal, institutional and taxation changes made private capital the primary arbiter of investment in the economy and sidelined the public agencies and private enterprises that supported productive investment and export-oriented firms.

Second, the market based financial system in Ireland (and elsewhere) does not operate in practice only through sets of buyers, sellers and rules but through a *network of market institutions*. However, while these institutions – competitive markets, stock markets, managerial authority, and credit rating agencies – were crucial aspects of a liberal market system, they did not enforce prudence and discipline but in practice encouraged speculation and indiscipline.

Finally, the third dimension consists of the various rationalities and justifications of action that actors draw upon in making and interpreting conditions and decisions. In a liberal market system, these rationalities rely heavily on *market talk* – justifications that give a central position to the autonomous effects of market processes. Chief among these in Ireland were the appeal to economic fundamentals and the belief in the self-correcting properties of markets.

Krippner (2011) documents that liberalising financial markets was initially seen in the US as a political strategy that could discipline inflation and socio-political demands. However, policymakers soon discovered that financial deregulation and low interest rates resulted in the opposite – a significant loosening of economic discipline. However, this unanticipated policy failure quickly proved attractive to policymakers. Similarly, in debates about the EU capital liberalisation directive of 1988, Germany wished to remove the possibility of capital controls even as France and the UK wished to retain that option, at least for bargaining leverage at least (Abdelal, 2007, p. 69) Hans Tietmeyer, the senior German official dealing with the issue, explained the German position in terms that echoed the US policymakers' belief in the market as a source of discipline: "We saw in full capital liberalisation the possibility for a test of the stability of the Exchange Rate Mechanism – a test by the markets of policy credibility. We wanted a test by world markets, not just European markets. ... would demonstrate that we had in Europe a stable fixed exchange-rate system with market-proved stability, rather than artificial stability provided by controls" (quoted in Abdelal, 2007, p. 70).

However, just as in the cases of the US and European integration, financial markets in Ireland promoted indiscipline, rather than the discipline that many had hoped for. The lesson of the Irish case may be that markets are not the overarching disciplinary institution that keeps the other institutions in a society "honest", but that they are simply one institution among many to be used for various purposes, for better and worse. The necessity of social and political regulation, decisions and debate cannot be avoided with an appeal to the arbitration of markets, which has proven so disastrous in the crisis of financialisation in Ireland.

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