

EXAM SPECIAL

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Students' guide to the financial crisis



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Most people didn't even notice the warning signs. In early 2007, some US financial companies involved in sub-prime mortgage lending started to get into trouble. Sub-prime lenders gave home loans to people who had trouble getting it elsewhere.

As the US Federal Reserve – the American Central Bank – started to raise interest rates from the lows of just 1 per cent reached in 2004, some of these borrowers started to struggle to make repayments. Slowly, a crisis was building.

Trouble brewing

New Century Financial was a company which specialised in the sub-prime business. Established in California in the mid-1990s, it had made millions for investors as it was listed on the stock market and its shares soared.

Its sub-prime mortgage financing seemed a licence to make money. Borrow from a bank at one interest rate and lend on to borrowers at a higher rate. Bundle up the loans into a package and sell them on to other investors, thus getting back more money to lend out. What could possibly go wrong?

It soon became clear what could go wrong. Borrowers stopped repaying. New Century had deals with investors to whom it sold the mortgages, obliging it to repay them if the mortgage loans were not repaid in their early years. In March 2007, it ran out of money. A month later, it filed for Chapter 11 bankruptcy and its investors had lost all their cash.

Still, the world did not seem to notice. It was a local problem confined to part of the US market. But the seeds were sown.

You are studying business or economics in school or college and your exams are coming up. As well as learning your course material, you are expected to be up to date on what has happened in the economy and business over the past few turbulent years. But are you? In the following four pages, we guide you through the essential details of the crisis, focusing on economic issues for the first two pages and on the business world on the following two. The two sections, of course, are inter-related

Investors and banks were watching and became more nervous of lending funds to each other. It wouldn't be long until the real crisis broke.

Major US investment bank Bear Stearns was founded in 1923 and had survived the Great Depression and two world wars. But it would not survive the sub-prime crisis. It had two large hedge funds – investment funds which managed people's money – which had taken money from investors, borrowed more on the back of these funds and taken huge bets on financial instruments linked to sub-prime mortgages.

As defaults on these mortgages rose, other banks which had lent funds to Bear Stearns started to circle and, in July 2007, two of the main funds announced they could not pay investors.

The crisis was now building fast. It was an American problem, wasn't it? Well no, actually. Many banks worldwide had invested in products linked to US sub-prime mortgages. Basically, some financial interest in these mortgages had been sold on in various forms of complex financial products over the past few years and, as the borrowers started to default, the value of these products collapsed.

In early August, BNP Paribas, a large European bank based in Paris, announced that investors would not

be able to take money out of two of its funds which had invested in these products. Now investors were getting really scared and the international central banks had to start pumping cash into the world financial system.

Economic theory teaches that central banks are the 'lenders of last resort'. Most experts thought this was only theory. But now the "last resort" had arrived. Central banks were buying various securities from commercial banks and giving them cash in return, desperately trying to get liquidity flowing and providing credit where others would not. They also started to cut interest rates, another key way in which central banks try to manage economies.

However, banks remained unwilling to lend to each other, meaning that the money being released into the system by the central banks was not having the desired effect. It was clear that we were now entering an unprecedented crisis.

From Wall Street to Main Street

The crisis spread through the autumn of 2007. In Britain, Northern Rock building society collapsed.

Northern Rock was typical of a new type of financial institution which relied on borrowing money

on financial markets to lend on to its customers. In the old days, banks took in deposits and gave out mortgages and other loans, but in recent years they had increasingly also borrowed funds from other banks to lend on.

Now, with banks less and less willing to lend to each other, this business model was in trouble. As savers heard of Northern Rock's troubles, they queued to withdraw their cash in an old-style 'run' on the bank. The British government had to step in and guarantee their savings and agree a wind-down plan for Northern Rock. The crisis had moved from Wall Street to the Main Street.

Through the rest of 2007, it was clear that it was not going to be fixed quickly. The interest rates at which banks lend to each other rose to historically high levels. Central banks injected billions into the markets in unprecedented moves, but this only calmed things briefly. Cuts in official central bank interest rates also had a limited impact. There were signs of building losses in the banking sector.

The year ended on a nervous note – with central banks pumping in more and more money – and warnings that growth in 2008 looked certain to be hit by the unfolding crisis.

Still, however, many continued to view it as a crisis in the financial

sector, without much relevance to the 'real world'.

But 2008 was to prove them wrong. In the early months of the year, the stormclouds were gathering. World stock markets fell heavily in January and a number of insurers also started to run into difficulty. In April, the International Monetary Fund rolled out some telephone numbers, warning that losses to the financial sector from the sub-prime crisis could reach \$1 trillion – that is one thousand billion. That is a one followed by 12 noughts, or a million million.

More ominously, it warned that the crisis was moving into mainstream areas of banking, such as commercial property and loans to business. Because banks were finding it hard to get hold of money, they were hoarding cash and cutting back on new lending.

In summer, the US government had to step in to support two major mortgage lenders, Fannie Mae and Freddie Mac.

Still, the view generally was that this was a problem for the banking sector. It became clear, however, that in summer of 2008, one year after Bear Stearns, there was no sign of the credit markets starting to ease.

Wiser heads in the financial sector warned that things could start to get nasty.

Late 2008: the storm

August was usually a quiet time in financial markets. Dealers went on holidays, trading volumes were generally low and little news came out of finance ministries and central banks. It wasn't long into September, however, before illusions about the extent of the crisis were shattered.

Increasing evidence of the impact of the crisis on real economies, including rising unemployment in key markets such as the US, sent stock markets plunging in early September.

Worse was to come. Lehman Brothers, the big US bank, filed for Chapter 11 bankruptcy. There was shock in financial markets that the US government had allowed this to happen.

Shortly afterwards, Merrill Lynch had to agree to an emergency takeover by Bank of America.

In Britain, Lloyds stepped in to rescue HBOS, major European bank Fortis was part nationalised and the British government had to step in to nationalise Bradford & Bingley.

In the US, the government announced a \$700 billion bank rescue plan, later passed by Congress. The British government announced its rescue programme in October.

As autumn turned to winter, it

was a tale of emergency interest rate cuts around the world, plunging stock markets and financial crisis in places such as Iceland and Ukraine.

By December, the US officially declared it was in recession, US interest rates were close to zero and world stock markets were 30 to 40 per cent lower than a year earlier.

Any hope that the crisis was going to be confined well and truly disappeared as the world faced into the greatest financial upheaval since the Great Depression of the 1930s.

2009-2010: Counting the cost

The full cost of the financial crisis only started to become apparent in 2009. It was by now clear that the collapse had triggered a major economic downturn by crippling the banking sector worldwide, hitting the flow of credit to businesses and consumers, destroying investors' wealth and shattering economic confidence.

The government announced a range of measures to try to stimulate growth, and new US president Barack Obama gained approval for a \$787 billion stimulus package.

The IMF said the crisis could cost the financial sector \$4 trillion – four times its original estimate (four and 12 noughts!).

As a result, major governments were forced to inject more capital into their big banks to keep them afloat.

By the middle of the year, it was clear that the world economy was going to shrink in 2009 under the weight of this extraordinary crisis. Moving into 2010, there was some hope that, internationally, the worst may be over. But it will be a long road back, both for the battered financial sector and for the world economy.

How the crisis developed

The economic crisis was swept around the world by a range of financial connections previously ignored by regulators worldwide and not identified as a danger by most economic analysts.

Sub-prime mortgages

The crisis started in a part of the US mortgage market, where lenders gave money to people who would normally have difficulties getting a mortgage because they had irregular income, a lack of a documented earnings record, insecure employment or whatever.

Many of these borrowers started to get into trouble as US interest rates rose from 2005 on. This worsened as house prices in some areas of the US started to fall, pushing borrowers into negative equity, where the value of their house was less than what they owed.

In previous years, when a borrower got into difficulties, it was only a problem for the borrower and the financial institution which had lent them money. A key to understanding the start of the crisis is to realise why this changed.

Securitisation

This is where banks parcel up bundles

of mortgage loans and sell them on to investors in various forms. Typically the investor pays the banks cash and in return is promised the mortgage repayments. This means that if the borrowers cannot make the repayments, the exposure is spread across the many investors who bought these products.

In turn, these investors sold on other interests in the sub-prime mortgage market to other investors in a range of other complex financial products. In this way, the risk was spread across the world, and nobody knew which investors were going to lose out. Fear spread around the financial system.

This meant that banks were increasingly loath to lend to each other. They did not know whether the bank they were lending money to was facing big losses – and whether they would ever get their money back.

Credit crunch

When banks stopped lending to each other, the financial system started running into trouble. This interbank, or wholesale, lending is a central part of the world financial system, allowing banks to lend funds in turn to businesses and consumers.

The Financial Times in late 2008 described it as a cardiac arrest hitting



Lehman Brothers: one of the first major casualties of the economic crisis

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the financial system worldwide. As the crisis developed, it became clear that the problems were much wider than just the US sub-prime market.

When banks cannot get hold of money, they do not have money to lend out. The demand for lending has also collapsed, as investors and consumers save rather than spend. So the money supply has fallen in most world economies and in Ireland. Even good busi-

nesses find it difficult to get hold of cash from the bank.

The debt mountain

The free availability of credit had pushed economic growth across the world economy in the 2003-2007 period. Interest rates had been cut to low levels after the tech bubble burst in 2000. Banks worldwide went on a

spree, lending money and reporting more profit, but storing up trouble. Property prices in many areas rose far too quickly, fuelled by this credit spree. Property prices in countries such as Spain and Ireland rose to extraordinary heights.

As the credit crunch hit, banks started to get nervous about these risks. Higher interest rates and slowing economic growth were already taking a toll on property prices.

A worldwide property crisis was thus another key way the crisis spread, with countries where prices had risen the fastest being worst affected. In turn this hit employment in areas such as construction and had an impact on the wider economy.

The real economy

We have already seen some ways in which the crisis moved from the world of finance into the real economy of income and jobs.

Once it took hold, the downward momentum took hold in other ways. Cuts in employment in the financial and construction sectors led to lower demand in economies, hitting other businesses. Deflation, with prices falling, means consumers have held off spending, hoping that prices will fall. Business and consumers have chosen

to hoard cash rather than spend. The financial crisis developed into a crisis of economic confidence.

Countries like Ireland, which had experienced high inflation in the past, also found that they lost huge numbers of jobs because businesses competing internationally were losing out, while the traditional job generators in the construction and retail sectors ran out of steam.

The government factor

The final reason we will consider for economic problems is the situation governments have found themselves in. They have spent billions of euros and dollars bailing out banks. At the same time, collapsing tax revenues have hit their income. This means governments have run up huge deficits of spending over revenue and are now having to cut back by raising taxes or cutting spending.

The Irish government has introduced a range of tax increases and spending cuts in the last three budgets, with more promised in future years. This reduces growth by taking cash out of the economy. But the government feels it has no option because it fears it will run into difficulties borrowing money on world markets if it does not reduce the deficit.

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Anglo Irish Bank: one of the first banks to be hit by the global economic crisis

TONY O'SHEA

Everybody hurts in fallout from crisis

From bank shares to take-home pay and loan conditions to house prices, the downturn has hit all levels of the economy

The economic crisis has hit every area of activity in Ireland, some more dramatically than others. A useful way to look at its impact here is to break it down into its effect on different parts of our economy.

The banking sector

The crisis started in the financial sector internationally, and this started to spread to Ireland through 2008. Bank shares were the first to be hit – with a notable run on the shares of Anglo Irish Bank on St Patrick's Day that year. However, it was September before the crisis broke fully into public view.

At that stage Anglo was threatened with bankruptcy as international depositors withdrew funds. The other banks were also being hit, as speculation grew about the extent of their losses in the property market.

The government responded by first providing the bank guarantee on the night of September 29, 2008. This meant that the government was guaranteeing the €400 billion-plus in liabilities which the six domestic banks had to creditors such as depositors and most bondholders, who are investors who lend money to banks.

This restored some calm, but by early the following year, it was clear that more needed to be done. The financial markets had lost confidence in Anglo Irish Bank, due to its huge property losses and evidence of malpractice.

So the government stepped in to nationalise it, in other words take it fully into state ownership. People who held shares in Anglo are likely to have lost all their money.

Also, by early last year, the scale of the losses the banks were facing from bad property lending began to become clear. Having commissioned an expert report, the government decided to respond by establishing the National Asset Management Agency (Nama).

This agency is buying the bad loans from the banks at a discount and taking them into the ownership of the state. This will shrink the bank balance sheets, but is designed to try to restore financial market confidence by removing a lot of the bad loans from the banks.

It creates another problem, however. Banks hold capital – cash and other readily available reserves – as a buffer for times when they lose money.

This capital has been run down by the losses they have incurred already and they will incur more losses on loans transferred to Nama, because the agency will pay them

less than the value at which the loans are held in their books.

The Financial Regulator, which oversees the sector, is insisting that the banks rebuild their capital reserves. This is called recapitalisation.

The two main banks, AIB and Bank of Ireland, are examining how much of this money they can raise from private investors. Getting new shareholders is the easiest way to raise new capital, while selling assets can also help.

The government has also said it will commit more state funds if necessary – it has already invested €3.5 billion in each of the two main banks in preference shares. The government is also going to have to put in billions of euro to recapitalise Anglo Irish Bank and Irish Nationwide Building Society.

The government hopes that when the bad loans are removed by Nama – this process is just getting under way – and the banks are recapitalised, they will be able to start operating normally again, raising funds and providing credit to the economy. The EU has to approve all these plans and is currently doing so.

The economy

The economy has been hit by a number of linked shocks. There is the fallout from the banking crisis. There is also the impact on Ireland of the international economic downturn, and there is the collapse of the property sector here, previously a key generator of growth. These have combined to create a savage economic recession – a period when the economy contracts.

Gross National Product is one of the best indicators of activity in the economy. Having risen by 6.3 per cent in 2006 and 4.4 per cent in 2007, growth turned to decline in 2008, with GNP down by 2.8 per cent.

However, the real hit was taken last year when, according to the latest Central Statistics Office figures, GNP fell by an astonishing 11.3 per cent, the biggest annual fall since records began.

As economic growth has collapsed, unemployment has shot up. The CSO estimated that 4.8 per cent of the labour force was unemployed in January 2008. By last month, this had risen to 13.4 per cent.

Different measures of economic activity can be found on the CSO website (www.cso.ie). However, they all show the same picture of a collapse in activity in 2009. The picture is a bit more stable this year, with the latest Economic and Social Research Institute forecast being for no change in GNP this year.

However, given the extent of the



Brian Lenihan, Minister for Finance, and Brendan McDonagh, chief executive of Nama

likely to be over 10 per cent of GDP this year, despite the cutbacks in the last budget. Also, the government has had to commit billions in revenue to the banking sector.

While some of this money will be paid out over a period of years, some has come from the National Pension Reserve Fund and some may be recouped in future years, it has all added hugely to the burdens on the exchequer over the years ahead.

The national debt is now rising quickly due to our high levels of borrowing. The state is also taking on other liabilities in relation to the banking rescue programme, some of which are not counted formally as part of the national debt under EU rules. For example, Nama will issue about €50 billion in special bonds – or IOUs – to the banks in exchange for the loans it takes on from them.

This is not being counted as part of the national debt, because the state is getting assets – the loans from the banks – in return. However, if the state ends up paying more for the loans than they are worth, then it will be a long-term cost to the taxpayer.

The public

Everybody has been affected by the recession in one way or another. Most seriously, tens of thousands have lost their jobs. Many people in the public and private sector have also had their pay cut, either base pay or bonus pay or through a reduction in hours. The pension levy has also hit take-home earnings in the public sector.

These factors, together with fear about further job losses and tax increases in the future, have led to a big collapse in retail spending.

In December last year, retail sales, excluding motor cars, were 6.4 per cent lower than one year earlier. Including car sales, they were 7.5 per cent lower.

There have been tentative signs of improvement in recent months, due to a pick-up in car sales – partly due to the government scrapping scheme – and a general slight recovery in spending in other areas. However, people are still concerned about employment, and many are still choosing to save more and spend less.

A big issue for many consumers is that they are still servicing debts built up during the good years, whether on mortgages, car loans or credit cards. Unemployment and falling incomes have made it difficult for many people to repay these debts and this may limit the growth in consumer spending for quite some time.

Business

Businesses have been hugely affected by the crisis. Turn to the feature on the next page to read about what it has meant for them.

Jargon buster

■ **Nama** – National Asset Management Agency. Set up to take certain property loans off the books of banks and into state ownership. It is taking on land and development property loans – originally valued in the banks' books at €80 billion. These are sometimes referred to as 'toxic loans' – the term which was originally used to describe sub-prime loans in the US. The majority – though not all – of the loans being taken on by Nama are partially or completely 'non-performing' – in other words, the borrowers are not able to make all the repayments or, in some cases, not able to make any.

■ **NTMA** – National Treasury Management Agency. Nama operates as an independent commercial agency under the aegis of the NTMA. The NTMA also manages the national debt and runs the State Claims Agency, which manages legal claims against various arms of the state covering personal injury and property damage. It also runs the National Development Finance Agency, which advises on the raising of funds for state investment projects. Finally, the NTMA manages the National Pension Reserve Fund, established to help to meet the cost of further pension liabilities. Money from this fund has also been used to help recapitalise AIB and Bank of Ireland.

■ **Bank capital** – capital is the cash and other readily available reserves which banks must hold to guard against losses. Cash invested by shareholders is one of the primary sources of capital for banks. For this reason the main banks will be seeking new cash from shareholders in the months ahead, either from the private sector or the government, to 'recapitalise'. Selling assets can also help banks to meet their capital requirements. The bank capital rules are set by the Financial Regulator.

■ **The Financial Regulator** – the regulator oversees the operation of the financial sector and sets rules to safeguard customers. The regulator used to operate as an autonomous entity – the Irish Financial Services Regulatory Authority – linked to the Central Bank, which is responsible for the overall stability of the banking sector. However, after the crisis broke, the government decided to restructure regulation, and the Central Bank and the regulator will in future operate as one body, under legislation now going through the Oireachtas.

collapse, there is still uncertainty about the outlook.

The government

The crisis has hit government finances hard. Governments always suffer during a recession because tax revenues fall and there are extra pressures on spending from higher

unemployment. However, in Ireland other factors have made it even worse this time.

The exchequer was heavily reliant on various forms of property taxation, which have now almost disappeared because activity in the property market is so low.

Government borrowing was more than 11 per cent of Gross Domestic Product last year and is still

Examine your economic options

By Bairbre Kennedy

TEACHER TALK

This is a very exciting time to be studying economics. So much has happened nationally and internationally in the last year that Leaving Cert economics has, now more than ever, become a 'live' subject.

Ireland's economic situation is continually being discussed in the media. Economic concepts are being analysed and debated by expert economists in all the newspapers and on the radio and TV.

The public, too, are getting involved and having their say on what the government should be doing next. The importance of economics as a real-life, relevant subject couldn't be more evident.

How can Leaving Cert students get a handle on all this? Certainly, reading newspapers, and listening to TV and radio commentary can make the subject come alive and motivate students to study.

Every topic on the course can be brought out of the textbook and into the real world.

The economics syllabus states that the objective of the course is to "develop in all our students an interest in everyday economics" and "to give students a general picture and an understanding of economic activities, patterns and principles".

In previous years, the exam has obviously followed these objectives and asked specific questions related to current economic activity.

For example, in 2009, students were asked to outline how the recent tightening in the availability of credit might affect a) the Irish motor industry, b) inflation and c) Ireland's balance of payments. Another question asked students to discuss the economic consequences of a slower rate of economic growth in Ireland.

In recent years, there seem to be more exam questions that focus on the capacity of students to apply the principles of economics to current economic situations. This is a clearly stated objective in the syllabus.

To score well in the examination, it's necessary for students to have a firm grasp of current economic activity. It's no longer enough when answering questions to include up-to-date information along with theory to illustrate a point.

Whole questions are being asked on current economic situations, and students are being asked to discuss the consequences, give reasons and even suggest courses of action a Minister of Finance should engage in.

In 2008, students were asked to identify possible ways in which the Minister of Finance could reduce the public sector wage bill. In recent months, this has been a contentious issue frequently debated in the media. These questions fulfil the syllabus's objective of achieving critical thought.

The key areas of current economic activity that are necessary for students to prepare are:

■ **national debt:** the reason for its increase and the positive and negative consequences of the increase

■ **banking:** the effect on the economy of a) the banks reducing the availability of credit and b) the recent fall in our credit rating. Other recent developments in the banking sector, such as Nama, why it was set up and its implications, and the nationalisation of banks, reasons for and arguments for and against.

■ **unemployment:** causes and how can government remedy it

■ **taxation:** arguments in favour of raising direct/indirect tax

■ **economic growth:** the con-

sequences of a slowdown
■ **trade:** implications of an increase in the value of the euro for the Irish economy; the merits/demerits of devaluation.

One invaluable resource for students is the State Examinations Commission website at www.examinations.ie. The solutions and marking schemes to all the questions referred to can be found here. It provides sample solutions with guidance on how to lay out answers.

Another good resource is the Central Statistics Office website at www.cso.ie. This website provides up-to-date information on key economics figures. So it's advisable for students to update their figures before sitting the examination.

The exam

The Leaving Cert economics paper is divided into Section A and Section B. Section A requires students to answer six out of nine short questions for 100 marks. Section B requires students to answer four out of eight long questions for 300 marks.

The examination lasts two and a half hours. Students are advised to spend 20 minutes on short questions and about 25 minutes on each long question.

Time left over should be spent going back over answers and completing unfinished answers.

When deciding how many points are necessary to gain full marks in a question, students should divide the marks by five. For example, if a question has 25 marks going for it, this would probably require five points.

A question that carries 20 marks would probably require four points. It's advisable to include an extra point to be sure you've enough points to secure full marks.

Section A: short questions

Short questions should be answered on the examination paper itself. The question is usually followed by headings making it very clear to students what is required in their answer.

For example, a question may read: 'State TWO functions of the Irish National Treasury Management Agency' followed by the headings, Function 1: and Function 2: with one line each for the answer.

If a question is not followed by headings, for example, 'Explain what is meant by the public sector borrowing requirement', students should make at least two points when answering this question. If there are three lines under the question students must fill up the three lines.

When choosing which six questions to answer, it is advisable to do the last four questions as they carry more marks (17 marks each). The first five questions carry 16 marks each.

Section B: long questions

The phrase 'state and explain' appears regularly on the paper. Start each point with a brief statement.

The statement can act as the heading of the point and then follow up with an explanation and/or example.

This answer layout should be used for other questions too. For example, if the question asks to outline, to suggest reasons for, to discuss the effect of, to explain this statement or to describe the consequences of etc.

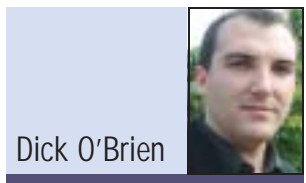
At the end of the examination, when students have rechecked all answers, a fifth long question should be attempted. Examiners will mark the best four long questions.

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The recession has not been confined to banks and developers, with every company in the country feeling the knock-on effects of the financial collapse



Dick O'Brien

While banks and property developers tend to dominate the headlines, the reality is that the recession has affected virtually all Irish firms. Many companies that were perfectly healthy businesses are now the victims of circumstances beyond their control.

The sheer size of the difficulties in the banking and property sectors has dragged the rest of the economy down.

Like a row of falling dominoes, problems in one area invariably create problems in others, until soon the entire economy is affected. Irish firms now have to cope with a variety of issues, such as falling sales, a lack of credit, customers not paying on time and job cuts.

Bank lending

Irish banks have suffered hugely in the recession. The main cause of this was that banks lent vast sums of money to developers during the property boom. With a sudden and dramatic fall in values, the banks found that the assets used to secure loans were worth far less than the loan amounts.

Meanwhile, many developers found that the market for their projects had collapsed, affecting their ability to repay loans. The result for banks has been that, if they were to recognise the true value of the loans on their balance sheets, they would need significantly more money in their coffers to cover their liabilities.

This has necessitated the government stepping in and bailing out the banking sector via the bank guarantee, the National Asset Management Agency (Nama) and plans to recapitalise the banks. However, the fallout from this has caused problems for many businesses.

The upshot of the banking crisis has meant that banks have less money to lend, and this has been a critical issue for many businesses. Banks have traditionally provided loans to people starting businesses or expanding their companies, whether for finding premises, purchasing equipment or raw materials or hiring staff.

Bank credit in the form of overdraft facilities can also play a crucial role in ensuring that firms have enough money on hand during the gap between delivering a product or service and receiving payment.

The banks have claimed that they are still lending to businesses, but businesses claim otherwise. For example, a recent study by small business representative organisation Isme found that 55 per cent of companies which applied for funding in the last three months were refused credit by their banks, compared to 42 per cent in October 2009 and 20 per cent in May 2008.

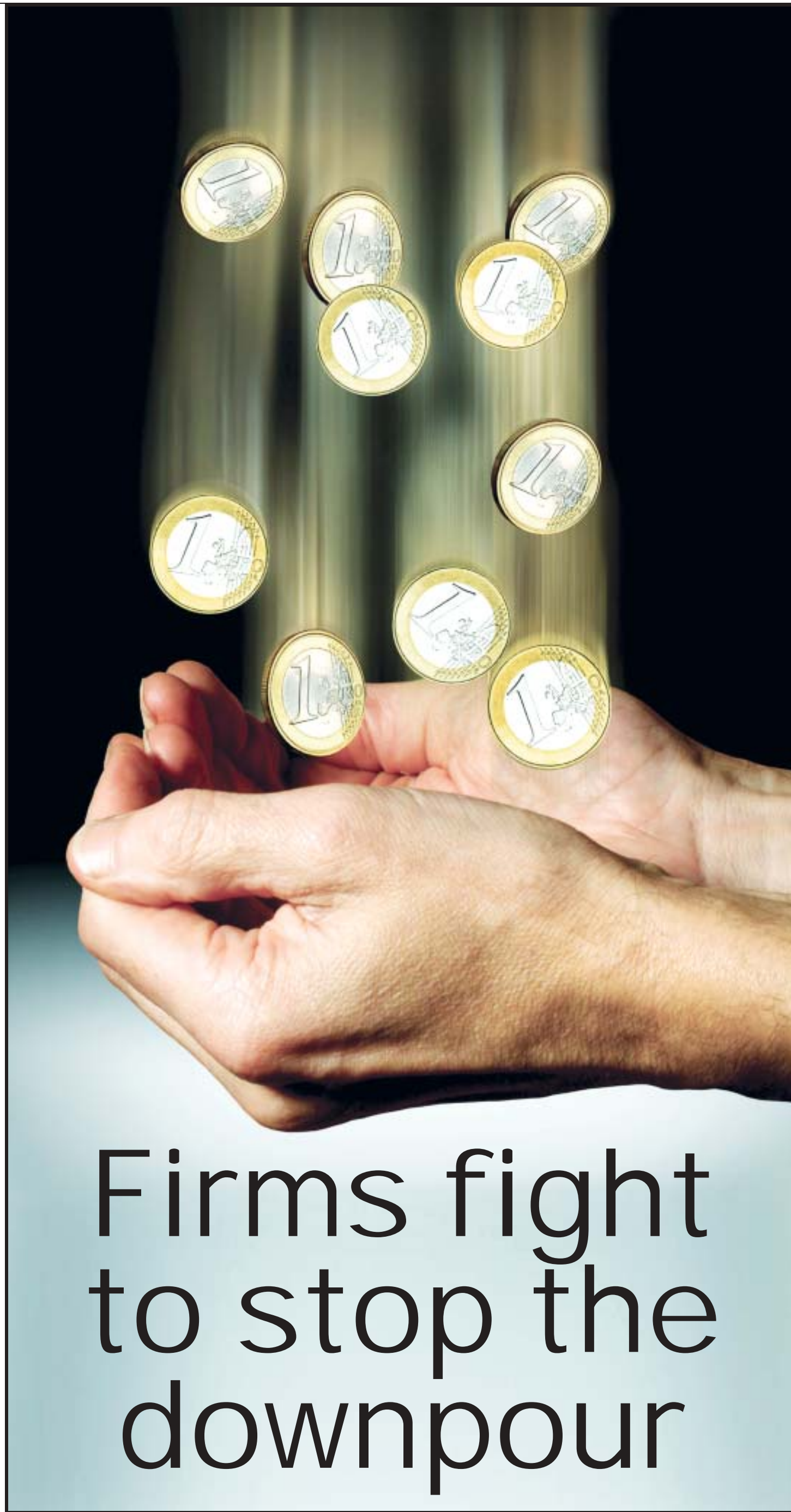
Of the companies surveyed, 80 per cent said that banks were making it more difficult for small and medium-sized businesses. As long as this problem persists, many firms will continue to struggle.

The banks have insisted that there is money for viable companies. The issue has been complicated by the fact that the collapse in demand in the economy has threatened the future of many companies.

In some cases, the banks fear lending money to companies which could go out of business. The real question is the extent to which viable businesses are not getting cash.

Venture capital

Banks are not the only organisations which provide money to businesses. Many new companies which require a lot of capital to get going or



Firms fight to stop the downpour

ALAMY

to expand will take money from investors who, in exchange, receive a stake in the business.

For larger, more mature companies, this funding can often come from venture capital funds, which collect money from private investors to put into a portfolio of companies.

Smaller new companies often rely on 'angel investors', private individuals with enough money and knowledge of the sector they operate in to give the business backing to get off the ground. It is this area in which companies have encountered the greatest difficulties.

Enterprise Ireland, the state body responsible for promoting the development of indigenous businesses, has expressed concern about the level of seed funding available. It has said that companies now have to work harder to try and raise money.

The problem is a longstanding one and began before the recession struck. Many Irish private investors opted to put their money into property during the boom years, as rocketing prices meant that they were likely to get a better return on their investment.

Because the property market has collapsed, a lot of private investors are nursing heavy losses and may

not have the money to invest in new companies.

Falling sales

One outcome of a recession is that consumers spend less. In some cases, it is because they have less to spend, either because they have had their salary cut or have lost their job. Those who haven't experienced a drop in income also often spend less, opting to save instead, in case their circumstances change further down the line.

According to the Central Statistics Office (CSO), in 2008 the volume of retail sales – the main barometer for consumer spending – fell by 2.8 per cent, while the value fell by 0.8 per cent.

In 2009, the situation worsened. The volume of retail sales fell by 6.8 per cent, while the value dropped by 11.1 per cent. The fact that the value of sales is falling more quickly than the volume shows the extent to which retailers have cut prices.

Businesses faced with a drop in sales can pursue a number of strategies. One option is to cut prices in a bid to encourage more people to buy their products or services. If the company operates on a tight

profit margin, this can mean that it will have to negotiate with suppliers to lower their prices also in order to make price cuts financially viable.

In addition, a company's competitors could adopt the same tactics, leading to a price war in which only the fittest will survive.

Another option is either to find new markets or start offering new products or services. However, both strategies come with their own costs.

Finding new markets involves sales personnel working long hours, in addition to travel expenses and the cost of setting up a supply chain once new customers are found. Creating new products or services also involves research and development time and can often entail the purchase of equipment along with expenditure on sales and marketing.

Late payments

Most companies which sell to other businesses deliver their products or services on credit. Terms vary depending on the company, but the standard is to expect payment within 30 days. While late payments are an issue companies have to deal with even in good times, the pro-

blem has become worse during the recession, with more and more cash-strapped customers being unable to pay their bills on time.

A recent survey conducted on behalf of Bank of Scotland (Ireland) in association with *The Sunday Business Post* found that 76 per cent of companies were encountering delays in receiving payment. Of that number, 38 per cent said that customers were taking more than 60 days to pay their bills, while 13 per cent said they had experienced delays of more than 90 days.

Late payments put an enormous strain on a business. Aside from the reduced amount of money flowing into a company's coffers every month, staff have to spend time pursuing customers for payment. In extreme cases, this can mean costly legal actions to recover money due.

There is also the danger that a customer could go out of business before it pays its bills, which means that a company will have to negotiate with a liquidator in an effort to recover the money.

Many firms which go into liquidation don't have enough assets to cover their liabilities, which means creditors will have to accept only a percentage of what they are owed.

Cashflow

The late payment issue has a tendency to perpetuate itself across entire business sectors.

When one company can't afford to pay its suppliers, they in turn may find themselves short of money and unable to pay their own bills on time.

The Bank of Scotland (Ireland)/Sunday Business Post survey found that, while 76 per cent of firms reported delays in payment from customers, 26 per cent also said they had experienced difficulties in paying their own suppliers as a result.

The upshot has been the creation of a classic cashflow problem. On paper, a company can seem to be generating enough sales to break even or even be profitable.

However, if money isn't coming into the company as fast as it is going out, the firm will find itself unable to pay its bills. This can result in suppliers shutting down lines of credit or refusing to trade with a company altogether.

The problem has also been amplified by the perceived unwillingness of banks to extend credit to businesses. The result has been that even companies with healthy sales can sometimes be forced to close.

Cutbacks

If a company has experienced falling sales, it will often be forced to cut back on its spending in order to maintain its profit margins or, at least, contain its losses. Cutbacks can be something as simple as promoting greater economy in an organisation, such as encouraging staff to turn off lights and computers every evening.

However, many companies are now faced with finding much bigger savings. This can entail shopping around to find cheaper products from alternative suppliers or negotiating with existing suppliers to drop their prices.

Investment in new equipment can be forsaken for a period, while staff perks such as expense accounts may be removed.

At this stage, a lot of firms are being forced to cut pay. A survey conducted by KBC Bank and Chartered Accountants Ireland found that 69 per cent of companies had reduced pay once, while 28 per cent had done so more than once.

Spending cuts can have a negative impact on businesses. If they are too severe, a company could find itself without the resources to take advantage of the opportunities that may arise when the economy improves, while pay cuts can have an adverse effect on staff morale.

Redundancies

For a lot of companies, spending cutbacks are not enough to balance the books and they are forced to take the ultimate step of shedding staff. There is no greater evidence of this than lengthening dole queues, which have more than doubled over the past two years. At the end of March, there were 435,000 people on the live register. This compares with 198,000 people in March 2008. While the live register is not a perfect measure of unemployment, its rise does indicate the trend of layoffs.

Implementing a redundancy programme is never easy. There is the obvious trauma of letting staff go and the resulting impact on morale for the people who remain.

In addition, companies must be careful to follow employment law in case they leave themselves open to legal action from departing staff. This involves paying at least the statutory minimum in redundancy payments and operating a transparent selection process for those being made redundant.

Labour market

Due to deteriorating employment prospects a growing number of people have opted to leave the country in search of work. During the boom years, Ireland experienced net immigration, with a large number of people from other EU countries and further afield coming here in search of work. That trend has reversed since the start of the recession and, according to the CSO, more people emigrated last year than immigrated.

A large proportion of those leaving the country are foreign nationals who are returning home after work has dried up here. However, a significant number are Irish people who are moving to Europe, the US and Australia in search of jobs.

Many of those leaving are highly educated, skilled people and, while jobs are in short supply, they will be needed again once the economy recovers and businesses begin to expand.

Changes to how business is done

The credit crunch and the recession have changed the world in which business operates. This is directly relevant to some of the concepts you have covered in your Leaving Cert business course. Changes to the domestic and international environment in which businesses operate are obvious. Here are just some other examples. There are many others you can think of yourself.

The marketing mix

Companies try to get the mix correct when they launch products, balancing what is on offer, where it is on offer and what it costs. Changing consumer demand has altered the picture for most companies. During the boom, consumers were often focused on quality, branding and fashion and were prepared to pay more for these. Now there is a much bigger focus on value. There are numerous examples of how companies have responded.

For example, restaurants have cut prices and are offering more and more special deals, as are hotels. The motor trade has slashed car prices, and advertising now emphasises value more than brand. Many retailers are now running what appears to be almost continuous sales. All areas of marketing have been affected, including pricing, target markets, advertising and promotions.

Management and employees

The recession has put a huge strain on people who are managing businesses and those who work for them. Managers have often had to cut costs to survive. Communication with employees is vital, as many are concerned about their jobs and their future. In some cases, management has worked collaboratively with staff, in some cases trade unions have negotiated new agreements and in other cases there have been industrial disputes.

The government, the biggest employer, has tried to strike a deal with staff on pay and reform, which union members are now voting on. This is to take account of the rapid deterioration in the public finances. A key theme is that strategies to manage change in a deteriorating economy have come to the fore.

Enterprise and entrepreneurship

It is a tough time to start a business. Many small firms are closing because of falling demand. However, there are still entrepreneurs starting up new firms. In some cases, they have experience of previous business. In other cases, they are entrepreneurs out of necessity – they have lost their jobs and are looking for new ways to earn money.

Identifying opportunities and raising finance are now much more difficult for entrepreneurs. However, in many sectors, there are still people taking the plunge. On page 10 of today's Money & Markets section, we profile a number of tech entrepreneurs starting up new firms.

International trading environment

In addition to problems in the domestic market, companies which export have also been coming under pressure. Demand has fallen in many international markets, though economic forecasters hope that recoveries in big markets such as the US and possibly Britain will help exporters over the next couple of years.

The strength of the euro has also caused problems to companies exporting outside the eurozone area, as it means that, to get the same euro price, they must charge more in the foreign currency, which is not always possible.

EXAM SPECIAL

in association with Business 2000

Time to get down to business

Business has never been a more fascinating subject, and keeping up with ongoing developments will help you in your exams, writes Siobhán O'Sullivan

TEACHER TALK

This is a fascinating time to learn about – and teach – business. Constant coverage on TV, on radio and in the newspapers means that topics from the syllabus, familiar to many students, are being discussed at length both in class and at home.

The syllabus document states that Leaving Cert business is “concerned with the understanding of environment in which business operates in Ireland and in the wider world”.

Students are more interested than ever before in what is going on in business, both nationally and internationally, and how government and the international environment affect business.

So how can this increased interest in business be translated into high grades? Keeping abreast of what is going on in the economy is essential for students who wish to achieve a high grade in the Leaving Cert.

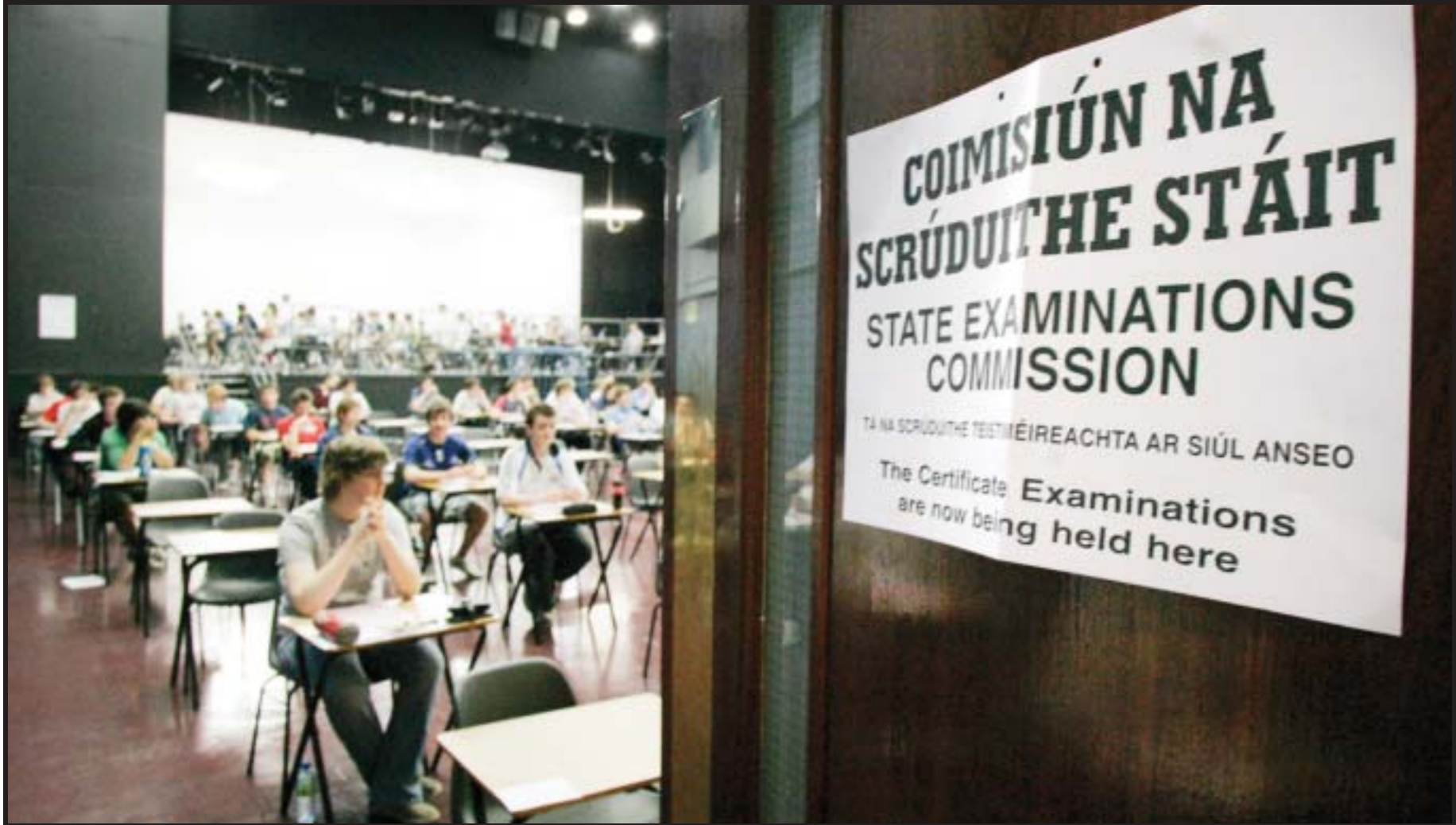
Students who want an A grade should demonstrate knowledge, application and analysis when answering questions. What this means in practice is that, when answering each part of a question, students must first make their point, then explain it and, where appropriate, give an example to show their understanding of the theory.

Relevant examples from the world of business can be used to illustrate answers and boost marks.

Reading newspapers, listening to radio commentary and watching TV programmes will help students put the theory they learn in class into context. TV programmes like *Dragons' Den*, *The Apprentice* and *Feargal Quinn's Retail Therapy* create interest in business and show practical application of the concepts in the syllabus.

Listening to radio commentary will keep students abreast of what is happening in the economy in general.

While the business exam tests knowledge of the syllabus, students



Students sitting the Leaving Certificate: keeping abreast of what is going on in the economy is essential for a high grade in the exam

PHOTOCALL

can improve their grade by using current business examples and being aware of what is happening in the economy.

Areas of the syllabus where this is particularly relevant include:

- people and their relationships in business (see article on opposite page for an Irish perspective and how interest groups like *Isme* are representing their members);
- conflicting interests and how they are resolved, especially between employers and employees;
- management skills and activities: control and the consequences of not maintaining control of credit and finance in the current climate are particularly relevant (read today's section on bank lending and how *New Century Financial* went bankrupt due to non-payment from its debtors);
- household and business manager (finance, insurance and taxation): basic cashflow (see sections on late payments and cashflow difficulties) sources of finance, the tax system and how it can be used to stimulate business activity;
- changing role of management: the impact of new technologies on personnel and business costs;
- monitoring the business: the importance of using, understanding and applying basic accounting ratios, eg, profitability, liquidity and gearing ratios;

- expansion: examples of companies involved in takeovers, mergers etc, eg, Kraft Foods' takeover of Cadbury and the implications of expansion for the stakeholders;
- categories of industry: changing trends in each of the three sectors: primary, secondary and tertiary (see the section on the worldwide property crisis);
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- business and the economy: the impact of the economic variables on business, eg interest rates, inflation, unemployment, taxation, exchange rates and grants, as well as the impact of business on the economy at local and national levels. All of these variables and their effect on the economy are outlined in the paragraphs on the debt mountain, the real economy, redundancies and the labour market;
- government and business: the role of the government in encouraging and regulating business;
- social responsibilities of businesses: examples of how businesses behave responsibly towards their stakeholders, analysing the impact of environmental issues on business; and
- international trading: analyse the

- expansion: examples of companies involved in takeovers, mergers etc, eg, Kraft Foods' takeover of Cadbury and the implications of expansion for the stakeholders;
- categories of industry: changing trends in each of the three sectors: primary, secondary and tertiary (see the section on the worldwide property crisis);
- types of business organisations: changing trends in ownership and structure;
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- social responsibilities of businesses: examples of how businesses behave responsibly towards their stakeholders, analysing the impact of environmental issues on business; and
- international trading: analyse the

changing nature of the international economy and its effect on Irish business.

Some examples of recent Leaving Certificate questions which test this type of knowledge include:

2009, Section 1 Question 6 Define the 'secondary sector' and outline two current trends affecting this sector in Ireland. (10 marks)

Sample solution

The secondary sector is made up of manufacturing and construction. Manufacturing involves taking raw materials (from the primary sector) and making finished goods from them.

Current trends include:

- a decrease in the numbers employed in the secondary sector, particularly in construction;
- increased competition in manufacturing from foreign firms; and
- rising wages from the early part of this decade resulting in higher costs and a loss of competitiveness. Some manufacturing businesses, such as Dell, have relocated to lower-cost economies, such as Poland.

2009, Section 3 Q1 (a)

Outline, using an example, the role of interest groups in the business world. (10 marks)

Sample solution

An interest group is an organisation that represents the views, objectives and goals of a particular group of people, eg Ibec represents Irish employees in negotiations with the government about pay and legislation. Interest groups attempt to influence decision-making through lobbying and negotiation.

Example: the Society of the Irish Motor Industry (Simi) is the official voice of the motor industry in Ireland, which consists of dealers, repairers, vehicles distributors, wholesalers, retailers, vehicle testers, etc. Its role is to represent the views of the motor industry by campaigning to the government, the media and the motoring public. (Source: www.simi.ie)

spending power of consumers, which will increase demand for goods and services;

- increasing PAYE rates for employees to raise additional money which would mean that the government could reduce commercial rates for business or alternatively increase grants to business eg, through County Enterprise Boards;
- reducing corporation tax to increase company profits, leading to higher retained earnings – these can be reinvested in the business to fund business expansion;
- reducing stamp duty on property to increase demand for new homes and stimulate the construction sector;
- increasing tax credits, with the effect of increasing disposable income for employees. This will stimulate demand for goods and services, which has a positive effect on business; and
- reducing Vat rates to cut the cost of goods and services which will make them more competitive. This will increase demand for Irish goods and services.

Q2 (c) Discuss how the Irish government could use the tax system to create a positive climate for business in Ireland. Use examples to illustrate your answer. (20 marks)

Sample solution

The Irish economy is currently in recession. Rising unemployment, the collapse of the construction sector and a difficulty in raising finance for business and households have led to a decline in business confidence. The government can use the tax system to create a positive climate for business by:

- reducing PAYE to increase

own businesses.

Richard Curran is presenter of *Dragons' Den* on RTE One

By Richard Curran

The banking crisis and the recession are affecting business in many ways. The main economic data – such as retail sales, unemployment rates and levels of borrowing – all give a picture of where things are. The crisis has also affected the small business sector and the challenges that face start-up companies. Entrepreneurs will continue to have good business ideas in a downturn, but their chances of success may be fundamentally altered.

Nowhere are the trends emerging in start-ups more evident than on the RTE television programme *Dragons' Den*. The reality TV show gives a good perspective on how the downturn is affecting the successful dragons and the budding entrepreneurs.

The first series of *Dragons' Den*, broadcast last year, was filmed over two weeks – one in November 2008 and one in January 2009. This year's series, which has just come to an end, was filmed over one week in November 2009 and one in January 2010.

The first obvious difference in this year's series is that entrepreneurs placed lower valuations on their ideas and businesses. This was partly due to the dragons giving some contestants a tough time over valuations in series one, but also reflects the changed economic reality.

Contestants are looking for smaller amounts of money, perhaps typi-



The Dragons' Den team: Sean Gallagher, Gavin Duffy, Sarah Newman, Richard Curran, Bobby Kerr and Niall O'Farrell

cally €10,000 to €40,000, rather than the more typical €40,000 to €150,000 of the previous year. The percentage of their businesses they are preparing to give away is also rising.

This reflects the fact that risk capital is now at a premium. With such controversy over the availability of loans from banks, cash investors are king.

In return, the dragons this year extracted a higher premium for the cash they were willing to put into

companies. In the first series, they would typically end up with 20 per cent of the company. In the second series, they were looking for 50 per cent at times, and were regularly coming away with 40 per cent or more of the contestant's enterprise. Those seeking less cash, and willing to give away more equity in return, did a lot better in the den this year.

A perennial problem for any start-up company is how to value it. A business idea may have a value, but if it hasn't generated profits, it

can't be valued on the basis of how much money it has made. An early business idea is solely about future potential.

Similarly, some contestants have great business start-ups with a lot of potential, but they have yet to make more than just a few thousand euro in profit. The investors can say that the company is mainly worth some number of times last year's profits, with a little extra for the potential of the idea.

In a rising economy, ideas alone

end. Many foreign workers are leaving in this downturn, but plenty of them will stay behind, and are clearly interested in starting up their