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THE GREEN INVESTMENT BANK:

DO IT NOW, MAKE IT BIG

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ABOUT PROMOTING GROWTH AND SHARED PROSPERITY

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The government has committed to setting up a 'green' investment bank. This will have attractive features, being at arm's length from the government and pursuing a two-fold objective: to make a return on its investments and to ensure those investments move the UK economy to a more sustainable, carbon-neutral orientation.

Yet the sums the government is committing are tiny: £3 billion, or about a fifth of 1 per cent of GDP, which can hardly have a huge effect on the economy. And the bank will not be able to borrow on its own account before at least 2015/16, by which time the current effort to reduce government borrowing was supposed to have achieved its aim, though that now is not expected. Generally, the impression has been created that, while the Liberal Democrats are keen on the bank, it is regarded with ambivalence by the Conservative party, which still mistrusts the notion of state involvement in finance or anything that looks like state enterprise. Despite the events of the last few years, a belief that things should be left to the market and to the private profit motive retains a powerful grip.

Energy and economics: Diagnosing the problem

Let us go back to first principles and think through the case for such an institution. One cannot take anything for granted, but there is probably a consensus at present that the UK, in common with other western economies, faces some problems that are not only serious but chronic – they will be with us for some time.

Thereafter, the consensus swiftly dissolves. The nature of such problems is disputed, so it is not surprising that there is no agreement on solutions.

Since the physicians disagree about the diagnosis, let's start with the symptoms. The UK economy, after a recession that was severe on at least some measures, is not rebounding. After a short-lived spurt it is growing very slowly. Unemployment is high and rising, and youth unemployment is a particular issue. During the past decade and a half, levels of indebtedness in the economy rose – the household sector, for example, pushed its debt from some 90 per cent of GDP to around 140 per cent, and is now likely to save more to try and restore its balance sheet. The state sector also borrowed and, in nationalising private debts that had gone bad and responding to recession with so-called automatic stabilisers, it has seen its own deficit rise unsustainably to over 10 per cent of GDP. De-leveraging by both sectors implies slow growth of domestic demand. If Japan is a guide, the process could last a decade or more. Restructuring the economy to respond to export demand will be a lengthy process requiring investment that is barely available. Moreover, the scope to recover rapidly through exports is limited when so many countries face similar problems themselves and are looking to take the same way out.

One of the difficulties we face is that current macroeconomic theory is ill-adapted even to describing these problems, never mind explaining or forecasting them. In the leading academies, so-called Keynesian theories emphasising fluctuations in aggregate demand as the reason for business cycles became terminally unfashionable long ago. The dominant paradigm attempts to explain all economic phenomena as a sequence of equilibrium states. Since nothing in these models permits the possibility of persistent error or coordination failures in a market system, all fluctuations must be the result of random shocks or actions of government.

After 2008, an increasing number of academic economists will admit in the bar that this type of theory is inadequate, indeed risibly unrealistic and irrelevant. But those private admissions do not influence what they teach students, the nature of their research, or what they must write to get published in the leading economics journals. Events have not led to the rehabilitation of unfashionable economists like Marx, Minsky or Keynes, who tried to address phenomena of the kind we are now living with, but rather to denial by economists and to bafflement and bemusement on the part of the public. Economics as a discipline is therefore falling increasingly into disrepute and provides no body of received doctrine or wisdom on which an article like this can draw. In particular, no alternative consensus or paradigm has emerged to challenge the market fundamentalism that still has a hold on the Conservatiave party.

On top of these undeniable problems there are others of a longer-term nature. The rapid growth of countries with very large populations, aspiring to living standards like those people in the west already enjoy, is contributing to rapid growth in demand for raw materials, particularly energy sources. Oil prices have remained high throughout a serious global recession. This is partly the result of speculative investment in inventories, but it suggests that large investments will be required in resource extraction in future if current patterns of commercial and industrial development are to be sustained worldwide.

Behind these concerns lies the contested spectre of global warming. Any statement made in this area will be disputed, but it is at the very least possible that the ecosystem cannot sustain the projected 2050 world population living in the resource-intensive and carbon-emitting way currently common in North America, Europe and Australasia.

While the UK cannot resolve this issue by acting alone, such a resolution depends, in the absence of a global consensus, on countries like the UK acting to set a good example and make international agreement more, rather than less, likely. It is true that democratic political institutions are ill-adapted to addressing problems with consequences that, though potentially vast, are uncertain and lie some way into the future. Such problems, however important, are not sufficiently urgent to impel sacrifices in the here-and-now while people argue about who should assume the burden of any such sacrifice. It must be accepted, therefore, that any country 'setting a good example' must do so partly as a matter of faith, not in the certain expectation that others will follow suit in good time.

In such circumstances, the case for a new state institution to finance a particular class of investments may appear as contentious as anything else. Yet the case is in fact compelling.

The case for green investment

Consider the longer-run issues first. Unless there is a collective decision to reduce national dependence on imported and increasingly expensive energy sources and to develop alternatives that emit less carbon, it is more than probable that investment on the requisite

scale will not occur. Certainly, it is not occurring at present. Forecasting technologies and prices far into the future is extremely hazardous and so, in the current climate, private companies will hesitate unless there is clear policy leadership that is backed up by the commitment of state funds. Policies that are not supported by cash and contracts are all too susceptible to change, leaving investors high and dry. Yet the social arguments for investment to save energy and develop new sustainable sources are clear.

- While absolute certainty is impossible, there is a strong scientific consensus that global warming is occurring and is being at least exacerbated by human activity. Developing energy sources that do not emit carbon is therefore the action of any good global citizen. Yet in the absence of a serious price on carbon emissions, market capitalism will not respond unaided.
- The cost of extracting oils and minerals from the earth's crust is likely to increase as poorer and more remote sources are exploited. Perhaps rising costs can be offset by technical progress but that itself requires a research effort. The market will undertake that effort on the scale required only if private companies can internalise all the benefits in profit – a highly unlikely scenario. Given the inevitable externalities, public policy action is indicated.
- There is no better time to undertake such investment than at a time of idle manpower resources and when people want to save ('de-leverage') more than companies want to invest, when the cost of borrowing is consequently very low by all historical standards. While contemporary economic theory would deny there can be a problem of deficient demand or that the state can do anything about it, observation, common sense and public opinion cannot be reconciled to that view.
- Indeed, with a growing clamour for the government to 'do something' about growth, a sensible programme of stimulating socially beneficial investments provides a political way forward too.

An investment bank is a good starting point for collective action because, as conceived in policy announcements so far, it has certain desirable characteristics.

- It is at arm's length from government, which is essential if the bank is to take technical and commercial risks, something that is hard for the civil service to do.
- It can foster a necessary degree of pluralism in tackling the issues. Public policy can become monolithic; there is 'a plan' and things outside the plan are rejected. A bank can be agnostic on whether there is a right approach and can support any well-thought-out and prepared project that meets its investment criteria. It can thereby catalyse and harness the variety and ingenuity of the private sector.

The UK government has shown reluctance to commit substantial resources to a green investment bank and has concluded that such a bank cannot borrow for several years because it is giving top priority to reducing the state's own deficit, which is by common consent running at an unsustainable rate. Borrowing more money, even via a new institution, is the exact opposite of what the government is trying to achieve. However this apparent problem is exactly that: apparent. In fact it is a mirage.

Investment, austerity and debt-aversion

To dissipate this mirage, consider what makes a state deficit unsustainable. To what problems does it give rise? Potentially, there are two. The first is that by borrowing to spend, the state crowds out private borrowing and acquires command of resources that would be more productively employed in the private sector. This can certainly be a problem and is frequently a risk. However, it is evidently a greater risk when the economy is operating at

full capacity and private demand for investible funds is high. At the present time the level of long-term interest rates is very low and the companies sector is cash-rich; there is no sign of financial crowding-out. The prospect is that investment inspired, subsidised or financed by the state would call into use resources that are currently underemployed.

It must be acknowledged that many economists would dispute this. They would argue for 'Ricardian equivalence': more state borrowing now means higher taxes later, and so people will save more now against future tax liabilities. The attempt to stimulate demand therefore fails because it actually frightens people into saving even more. There are two reasons why we need not be detained by this argument. The first is that the operations of the state green investment bank (SGIB) will not necessarily entail higher future taxes – a point to which I return. The second is that – except in pathological cases where state debt becomes very high, as is perhaps currently the case in Japan, where government net debt is 225 per cent of GDP compared with almost 70 per cent in the UK – most citizens are unaware of the level of debt and do not alter their own savings decisions in view of government finances. The belief that people act 'as if' they take account of something that in fact they don't recognise or consider is the kind of superstition that requires at least one degree in economics to cultivate.

If we dismiss crowding-out in current circumstances then we are left with the second problem, what we might term a transfer problem. As governments continue to borrow, their debt rises. This debt requires servicing. Since the state lives over many human generations, the debt need not be repaid; it can be rolled over for as long as there is a demand for government bonds as a relatively safe asset and store of wealth – nevertheless, interest on that debt must be paid. The higher the debt rises as a proportion of GDP, the larger the proportion of GDP the government must raise in taxes to pay interest to bondholders. For example, when debt reaches Greek levels of 150 per cent of GDP, if the interest rate is 5 per cent then the government has to raise taxes to the value of 7.5 per cent of GDP just to pay the interest owed. If selling the debt requires higher interest rates then the problem is compounded.

Now this does not use up resources or crowd out any particular private activity: it is just a transfer from the pockets of one group, the taxpayers, to another, the bondholders. Yet taxes, however used, are unpopular. If the transfers get too big they may become politically difficult to achieve; they may certainly inhibit a government raising taxes to spend on the things that it is supposed to provide, like health and education. There is a legitimate case, therefore, for restricting government deficits that imply a burden on future taxpayers.

However, not all state spending and borrowing implies such a burden. The standardised national accounts of the OECD make a distinction between general government spending and the spending of public corporations or parastatal bodies or enterprises. The former is financed from taxation; the latter are bodies with their own balance sheets and revenue sources. Those revenues, not taxes, are the primary source of funds to finance their debts.

The UK is anomalous in *not* making that distinction. Everything in the state sector in this country has its borrowing lumped into the Public Sector Borrowing Requirement. Even when the railways and the central electricity generating board were in the public sector, their investment was financed by issuing gilts and counted as part of public borrowing. In Europe, the Maastricht criteria that attempted to restrict government deficits in the eurozone to 3 per cent of GDP applied to general government only. In France, for example, it would not have applied to bonds issued by SNCF to finance railway

investment (though government subsidies to the railways would, of course, be counted as general government spending).

A state bank could issue bonds with a full government guarantee. So long as that borrowing went to finance investments with an expectation of returns, it would not be part of the general government deficit. So long as revenues were forthcoming to cover the cost of servicing the debt, the SGIB could borrow as much as it liked without placing any additional burden on taxpayers. The transfer problem would not therefore arise.

With no crowding-out and no transfer problem, there is no reason why such an institution should not access the capital markets even as the government attempts to reduce its 'own' deficit. That borrowing can occur as soon as the institution is ready and worthwhile proposals are advanced. There is no reason to wait for four or five years. On the contrary.

Guaranteeing risk and maximising investment power

Treasury economists will immediately protest that the government guarantee means taxpayers are ultimately liable for the bank's borrowings. If revenues fail to appear, the taxpayer will have to stump up after all. This is of course true and we should take account of it – there is no point in operating a SGIB without being prepared to take on a certain amount of investment risk and that risk should be fairly acknowledged.

Some of the technologies that will drive alternative energy sources are unproven, though generally promising. Carbon capture in fossil-fuel-driven power stations and tidal energy are two examples. Given the unknowns, cost overruns are quite likely in bringing to fruition projects that employ these approaches. There is little point in a SGIB unless it is prepared to invest in well-planned projects of that type. After all, even UK commercial banks will invest if you *guarantee* them a return. Suppose the SGIB backed technologies that did not work or invested in loss-making activities; it might well not cover the full cost of its debt. It would have to be spectacularly unlucky and incompetent, however, to invest in assets that provided no revenue whatsoever and had no resale value at all. By counting, as HM Treasury does, all the borrowing of such an institution as government borrowing, they are assuming, in effect, that it is 100 per cent likely to go bust and that the recovery rate on its assets would be zero – assumptions that appear reasonable only to Treasury officials.

There is a better way. The government should consider what the market rate is for insuring the bonds of an institution against default. What premium does a public corporation have to pay an insurer to get its bonds rated triple-A? Usually it is a few per cent of the value of the borrowing. Since the government would, in effect, be extending that insurance to the SGIB, it can either charge the premium to the bank or enter it into the government deficit as its acquired liability in respect of the activities of the bank.

The government's own bonds can be insured against default for about 0.8 per cent but a more realistic comparison may be with German Landesbanken, state-owned savings banks. They do not have a great investment record in recent years since several invested quite heavily in American mortgages. They are owned by the German *Länder* rather than by the federal government but they are regarded by the market as having an implicit guarantee. It is hard to think a British investment bank with a central government guarantee would be regarded as less creditworthy. Credit default swaps on a Landesbank cost generally less than 3 per cent. That means that the UK government's pledge of £3 billion for a SGIB would be best-employed not to make loans but as the reserve to back a guarantee. At 3 per cent, it could then underpin a balance sheet of £100 billion. That is a material sum: disbursed over five years or so that amount could raise investment in the

UK by more than 1 percentage point of GDP per year. And if those investments leveraged in private capital then a very important boost to investment would be achieved. This could begin to happen in the next year or two, just when it is highly likely to be needed to spur growth in the economy.

At present, government 10-year bonds carry an interest rate of less than 3 per cent. Also, 30- or 50-year bonds bear low interest rates, no greater than the current rate of consumer price inflation. With a government guarantee, the bank could borrow on similar or only slightly more expensive terms. At these interest rates, a great many projects should make a positive return. Certainly, some projects will make a loss but not all will do so. There already exist well-tried techniques for saving energy use, for example, that could be profitably employed. Returns may not be spectacular but risks are equally low. In short, there are no grounds for fatal pessimism about the prospects of a green bank. Moreover, its prospects are improved further by the fact that, by construction, the SGIB would be operating with the grain of government policy, looking to take advantage, for example, of subsidies available on some forms of power generation, at the expense of others.

Furthermore, the SGIB itself will not internalise all the benefits of its operations. To the extent that it helps companies and individuals to generate skills and know-how in emerging technologies, it will benefit the economy more widely. That should in turn benefit future government net tax receipts. These potential benefits should not, however, be included in the analysis of potential investments. It will be important that the bank obeys normal commercial disciplines if it is to be self-financing.

An additional area where the bank can make a contribution is in raising the standards of carbon auditing. If the SGIB is to be truly green then its projects should meet two separate criteria. One, they should be self-financing to the bank (whether or not they take advantage of subsidies from other sources) but, two, they should contribute to a reduction in carbon emissions. To ensure the latter is the case, full whole-life carbon audits will frequently be required. These will surely improve general understanding of what are sensible approaches and what are not.

Economic theory: Always late to the party

We are leaving a period of market fundamentalism during which it was assumed that markets would always work to allocate resources in the best way possible. There was no case for collective action, it was thought, unless a specific market failure could be identified. Such failures were supposed to be exceptional and little thought was given to distributional issues, whether among the population at present or between the current and future generations. Even if a market failure was identified, it was best handled by attempting minimal interventions to regulate prices. Government failure was assumed to be more pervasive and deadly than market failure, so setting-up state institutions was a no-no. To be sure, the real world had a habit of breaking in and from time to time the ad hoc and pragmatic reactions of government cut across such doctrines. The embryonic green bank proposal itself can be seen as an example of that.

The events of recent years can only be understood and tackled using concepts owing to Marx, Schumpeter, Keynes and Minsky, invoking inevitable failures of information, coordination and the pervasiveness disequilibrium. So far, that fact has rocked but not demolished the edifice of market fundamentalism which continues to dominate academe and the UK Treasury. Cognitive dissonance is now so great, however, that we can hope and believe that a green investment bank will not only be established but will be expanded

and accelerated to be significant economic actor, even if only as an ad hoc and pragmatic response to evident problems and without the benefit of ideological endorsement.

Theoretical blessing will surely follow later. Keynes, who wrote in 1936 in response to the problems of 1929–33, was only believed and adopted in the academies after 1945, when his model and policies were becoming less applicable. Market fundamentalism and the Lucas-inspired school of macroeconomics arose in reaction to the corporatism, capital controls, full employment and creeping inflation of the post-war era. It became popular in an era of globalisation, extension of capitalism and unrestrained financial markets that was more like the 19th century economy analysed by Marx – conditions where it was useless. We can rely on economists in roughly 10 years' time to devise models appropriate to our current concerns and to conclude that institutions like a state investment bank are thoroughly appropriate – just in time to be wrong about whatever comes next. Roosevelt's New Deal preceded publication of the General Theory. Once again it is time for action; the theoreticians will justify it later.