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The case for a national investment bank

Gerald Holtham

Public sector borrowing for investment can play a major role in securing private growth.

Since the crash of 2008, bank lending has not merely proceeded at a slower pace; outstanding loans have fallen, and continue to do so. In fiscal year 2010-11, bank advances to the UK private sector were some £2008 billion. In 2011-12 they were £1931 billion, a 4 per cent decline. Over the last three months they have averaged £1917 billion. As a number of commentators feared or predicted, we are tracing a path quite like that of Japan after its crash of 1990.

Banks are anxious to rebuild balance sheets. The household sector is paying down excessive debt. Companies are either unwilling to borrow and invest given the prevailing uncertainty, or unable to access loans at rates they find attractive or even supportable. The government is cutting budgeted expenditure in an effort to reduce its deficit. The economy has therefore grown slowly, with low rates of gross fixed capital formation. Business investment remains some 14 per cent below its 2007 peak in real terms.

The lack of a post-recession bounce has led to a lack of productivity growth. Unemployment has been less bad than might have been predicted from past cycles, however, owing to a fall in productivity, associated with greater wage flexibility. But now, with the economy almost static in recent months, we have both rising unemployment and slow growth of productivity. From the beginning of 2003 to the

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cyclical peak at the end of 2007, annual productivity growth per worker averaged 2 per cent in the UK. Subsequently it has averaged -0.7 per cent. Even measured from the third quarter of 2009, when the economy returned to growth, it has averaged only 0.7 per cent, less than half its historical average.

Given the international situation, especially the European crisis, the main factor inhibiting investment is probably absence of demand. However, small firms in particular complain that it is hard to get bank finance without paying extra fees or offering unusual guarantees. According to an ONS survey of some 77,000 small and medium-sized businesses, published last year, the proportion of businesses succeeding in loan applications fell from a permissive 90 per cent in 2007 to 65 per cent in 2010.

Pressures on the banks to raise reserves, adopt less risky strategies and generally improve their finances do not go very well with pressures to increase lending to business, especially small and medium-sized enterprises (SMEs).

These issues have to be separated. A shortage of capital for SMEs will not be solved by making banking safer, more responsible or even more inclined to make longer-term investments in what Adam Smith would have recognised as productive businesses. My view is that these things will not be achieved by regulation but by changing the capital structure of banks.

In particular there is a case for unlimited liability in banking. Ordinary shares and shareholders would continue to exist and afford access to capital, but there should be a new tier-zero of capital, provided by the Board of each bank. This would be senior to ordinary equity but would carry unlimited liability. When a bank went bust that would mean the Fred Goodwins of the world would probably be bankrupt too. In those circumstances it is less likely that banks would gear their balance sheets to the extent that they did before the last crash. And if they did we should at least have the satisfaction of seeing miscreant directors stripped of their worldly wealth, rather than retiring with accumulated wealth and large pensions as a result of their speculations. This approach worked well enough when investment banks were partnerships, and continues to work in the Lloyds insurance market.

The long-term problem of 'growth finance'

Such a change may be desirable, but it will not solve the cyclical problem of

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deficient demand for and supply of investible funds in a depressed economy. Moreover, not all the problems of lending to business are cyclical. The Macmillan Report of 1931 identified a 'Macmillan gap' in stable, longer-term finance for smaller businesses in the UK - and contrasted this situation with that of Germany, where relations between banks and industry were closer. As a result of that report, the Industrial and Commercial Finance Corporation was set up in 1945 by the leading banks and the Bank of England, and it eventually became the largest provider of growth capital in the UK. However its focus subsequently shifted to include large companies, and in 1987 the banks who were shareholders sold out, eventually leading to the company, now called 3i, being publicly listed. It has subsequently tended to concentrate on financing management buy-outs.

The changing nature of ICFC arguably left the original gap unplugged. The government commissioned another study, chaired by a former 3i executive, Chris Rowlands, which reported in 2009. Rowlands concluded:

> Gaps in current data and analysis make it difficult to draw any firm conclusions on the existence of a permanent gap in the provision of growth capital. However, the underlying market issues, together with anecdotal evidence, suggest that a gap currently exists. In addition, we can say with some confidence that unmet demand for growth capital is likely to increase as recessionary effects weaken balance sheets ...

Rowlands identified the gap as being worst in the range where companies sought finance of £2-10 million, argued that so-called mezzanine finance was the best way to plug the gap, and asserted that scale was required - 'perhaps through an institution, which would also set the overall strategic direction ... and ensure there was not "mandate creep"'.[1]

This sounded very like a call for a new ICFC, which this time should not be allowed to creep away from its original mandate as short-run profit-maximisation came to dominate the consideration of its shareholders.

Subsequently, a number of the commercial banks have got together to establish a Business Growth Fund but it concentrates on equity investments rather than the mezzanine finance recommended by Rowlands. It notionally has £2.5 billion

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to invest, but it is doubtful whether it will operate on a scale that is macro economically meaningful in the right area. It came into existence, like the ICFC, as a result of pressure from, and negotiation with, government. But since the money comes from commercial banks, how long will it be before it is used for lower-risk management buy-out schemes rather than for investment in small businesses? It seems unlikely that banking culture will change merely because a new fund has been set up. Notably, Santander opted out of the BGF, ostensibly because it did not do what the Rowlands report recommended; and it has set up its own mezzanine finance fund for SMEs with the aim of fostering new commercial relationships. It is, in short, acting like a Continental rather than a British bank.

A national investment bank

A number of commentators have made the case for a national investment or development bank.[2] The government has given some sanction to that approach with the notion of a 'Green Bank', although the plan is for something rather small, with a state commitment of £3 billion and a start date not sooner than 2015, by which time the government was hoping that the budget deficit would have been reduced to an acceptable level.

There are three different, though not distinct, functions that such a bank could discharge. First it could finance necessary infrastructure development at a time when interest rates to public bodies are very low and there is spare capacity in building and civil engineering; second, it could finance more speculative investment in projects using new 'green' technologies still requiring commercial development; but, third, it could provide mezzanine finance to small and medium-size enterprises. Each function could be carried out in a specific division of a national investment bank.

Even before recession, the UK was a country with relatively low investment rates compared with similar European countries. Whereas the ratio of gross fixed capital formation in the UK tended to fluctuate around 17 per cent in the past decade, in Germany it was 19 per cent and in France 21 per cent. The UK transport system compares poorly with the high-speed railway infrastructure and motorway mileage of its nearest neighbours. And while nuclear power is a divisive issue, French single-mindedness in using nuclear power to achieve self-sufficiency with low carbon

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emissions has no UK counterpart. A substantial effort is currently needed to make the transport improvements that would prevent UK economic activity becoming increasingly unbalanced towards the southeast corner, and to make the energy investment necessary to meet carbon emission targets. Yet instead of a substantial effort we have delay and retrenchment.

Moreover, the government's reliance on monetary policy to maintain aggregate demand is most unlikely to be effective. The UK does not face a mere cyclical recession where full employment will soon be restored by the automatic self-righting characteristics of the economy. The world faced a growing problem of effective demand even before the financial crisis, as countries like China, where profits make up nearly 50 per cent of GDP, relied on exports and associated investment to provide much of their dynamism and employment growth. As wages in the West, under the pressure of globalisation, lagged GDP growth, only very low interest rates kept debt growing and enabled spending to keep up with output. The debt bubble has now burst, and a possibly long period of adjustment and deleveraging by Western households and businesses is in train. Future attempts to reflate the private debt bubble through easy money are no more likely to work than recent episodes of 'quantitative easing'. If governments shy away from taking on the debt that other sectors wish to run down, demand and growth will remain slow.[3]

But can the state act when it is already running an enormous deficit? The answer is yes, but the key word is enterprise - public enterprise.

Why does a deficit matter? In a situation of chronic underemployment, we can discount the notion of an over-large public sector 'crowding out' private activity. The real problem is that servicing public debt implies a burden on taxpayers. It involves transferring large sums of money in future from taxpayers to bond-holders, domestic and foreign. If the deficit stays too big too long the debt burden becomes enormous, the transfers become infeasible - and there is trouble.

But, as is often pointed out, it is what the deficit is used for that matters. If it is used for consumption in the current period, future taxpayers have no compensation for the transfer payments they must make. If it is for investment, there will subsequently be assets, which in principle will raise national wealth and standards of living and provide an offset to the obligations of taxpayers. This was the principle behind Gordon Brown's 'Golden Rule'.

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Yet in certain circumstances, a deficit does not imply any burden on future taxpayers at all, whether balanced by assets or otherwise. And if the deficit did not imply a burden on future taxpayers, it would be a problem only if it were making an excessive call on resources because employment of capital and labour was full and inflation threatened. That is not the current situation, and, as was argued above, it is unlikely to be the situation for some considerable time given current imbalances in the world economy. Therefore, at present, a deficit that was not a burden on taxpayers would be no problem at all.

If a public-sector entity borrows to invest in assets to provide marketed services, thereby generating a revenue, the deficit caused by such borrowing does not then become a burden. It is the revenues it generates, not taxes, that service the debt.

Such investment to provide marketed services is, therefore, the way out of our chief problems. It can provide essential infrastructure and support demand while not adding to the burden on future taxpayers. The investment must be in assets whose output would be sold, rather than being provided free at the point of delivery. Railways would therefore qualify but not schools; toll roads but not free roads.

A national investment bank need not imply a dirigiste approach to economic activity, or the nationalisation of industries. Indeed one condition for the provision of capital would be the expectation that any project or recipient could generate a market return. While investment decisions would have to be consistent with government policy on energy and other matters, they would be made at arm's length from government, and on sound commercial principles. Moreover providing commercial loans to SMEs, which is evidently not dirigiste, would be a complementary activity. State-driven infrastructure investment could help provide the demand that would in turn stimulate private demand for investible funds. Both the demand and supply blades of the credit scissors would be sharpened.

The infrastructure department of an investment bank would provide finance and take preference shares in joint ventures, for example to hugely extend high speed rail networks, build tidal power stations on the west coast, and - where justified - build relief toll roads. If we wanted to create one million jobs via this programme, assuming the unaided private sector would create the rest, the investment would have to be at least £40 billion, some 3 per cent of GDP. Given that boost to demand, there would surely be a demand from SMEs for the mezzanine finance that another department of the bank could provide.

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Whatever the precise details of the financial structures created, the essential idea is to stand the Private Finance Initiative programme on its head. Instead of getting the private sector to raise expensive finance to build assets and lease them to the public sector, a public sector entity would raise cheap finance to procure assets and lease or sell them to the private sector for operation, or provide lucrative loans to businesses, thereby servicing its debt.

Currently HM Government can borrow for twenty to fifty years at an interest rate of about 4 per cent. Indexed debt has a real return of less than 1 per cent. Many projects that would be viable at those rates are at best marginal in projects relying on private financers. An example is the M6 relief toll road around Birmingham, which lost about £25 million last year for its owners. Its operating profit was some £33 million, but debt service of £58 million put it into the red. That debt service implies an effective interest rate of just over 8 per cent. But at 4 per cent it would pay its way, even before consideration of social benefits such as reduced congestion elsewhere. A national bank with an implicit government guarantee could borrow at such rates.

Such low long-term interest rates betray a market belief that idle resources and cheap money will be with us for a long time to come. For the reasons cited above, that expectation is probably right. So this is a wonderful opportunity for the state to do two things. First it can make all those infrastructure investments that it normally cannot afford on much better terms than usual, and that flow of orders will in turn induce private companies to expand their own capacity to meet the demand - especially if state procurement policies look to foster domestic supply chains and medium scale or smaller businesses. Second, if private credit of the right kind is lacking, it can lend to smaller companies, and profit from the success of their activities.

This will tackle the problem of deficient demand, and help to promote growth through the creation of a new deficit - a largely self-financing deficit. But it will not remove the need to reduce the current deficit, the one that is a burden on future taxpayers. However, to the extent that the policy fosters economic growth, it will cause the current deficit to fall as a share of GDP - the metric that matters if we are trying to assess how big a burden it is. On balance, the government cannot avoid a policy of fairly sharply retrenching current expenditures and with them the current deficit. That is a consequence of the fact that the Labour government, together with

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most commentators, over-estimated the trend growth of the economy and allowed public expenditure to grow much faster than the growth of revenues, even before the recession and banking crisis struck. But the consequent demand and employment hole can be filled by enterprise facilitated by a national investment bank.

In the current excitable state of global bond markets, would such a policy be acceptable to those markets? The answer is surely yes. The deficit which is publicised in most countries, and which is the objective of fiscal policy, is the general government deficit, as defined in OECD standardised national accounts. Borrowing by state entities for commercial purposes is excluded; the latter sort of borrowing is not included in the Maastricht criteria governing European deficits, for example. The UK is unusual in not making any such distinction, and in lumping all public sector borrowing, irrespective of its nature or its means of finance, into the PSBR. The origin of this practice seems to be the centralisation of public sector borrowing in the UK, which has never had post office bonds or railway bonds as other countries have done but has routed all borrowing through the gilt market. That may well have been economical, in that it eliminated spreads between different classes of public bond and led to cheaper finance. Unfortunately, however, it also led to the use of the public sector borrowing requirement as the appropriate target for fiscal policy. That was illogical. There must be quantitative restrictions on debt that is to be financed from taxes. But commercial borrowing can expand so long as the expected return (including some risk premium) exceeds the borrowing cost.

Treasury officials are rightly concerned that state borrowing or state guaranteed borrowing, even for commercial purposes, leaves taxpayers bearing some risk. After all the best laid schemes of mice and men, as the poet says, 'gang aft agley'. When they do, the taxpayer is stuck with the bill.

That means that when the government guarantees the debt of a state investment bank, if it does not charge the bank for its debt guarantee, it must put the value of that guarantee on its own balance sheet. It can get the actuarial value of the guarantee assessed by independent authorities. Typically it will be around 3 per cent of the balance sheet of the bank, or much less. It is appropriate that risk should be acknowledged and, in effect, offset in that way. Contrast that, however, with the current policy of putting 100 per cent on the balance sheet. Given independent risk assessment, the markets would be perfectly content. The UK might even get brownie points for rational policy-making.

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Notes

1. *The Provision of Growth Capital to UK Small and Medium-sized Enterprise*, The Stationery Office, November 2009. Mezzanine finance is essentially debt, in that it affords the lender no control over the company. However, while it carries interest like simple debt, it includes provision for the lender to take a share in the profits of an enterprise once the latter has achieved a threshold return.

2. See Robert Skidelsky, Felix Martin and Christian Westerlind Wigstrom, *Blueprint for a British Investment Bank*, Centre for Global Studies 2011; Gerald Holtham, *The Green Investment Bank: Do it now, make it big*, IPPR 2012.

3. For an explanation of this state of affairs see Gerald Holtham, 'Workers of the World Compete', *Prospect*, December 2008.

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