GRASPING THE OPPORTUNITY

With the right backing from government, the Green Investment Bank has the potential to unlock huge opportunities for investment and innovation, to drive a greener economy. **Dimitri Zenghelis** makes the economic case

The establishment of a Green Investment Bank in the UK was the centrepiece of the 2011 budget's green policies. This welcome and long-anticipated move will lever £15 billion of private sector investment into green projects, according to the UK Treasury, on the back of a public capitalisation of £3 billion.

However, by not allowing the bank to borrow until 2015-16, and even then only if public debt targets are met, the government risks missing a unique opportunity to tap into much larger flows of private investment and innovation without large public expenditure. This would create viable new markets that would boost the economy and provide a home for record levels of private saving seeking higher risk-adjusted returns.

The UK Treasury's reticence to extend public borrowing at this time is understandable. Contingent liabilities generated through Green Investment Bank lending push up measures of public sector indebtedness. There is legitimate concern that markets may react negatively to such figures by raising the costs of financing UK debt. But without covering policy and regulatory risk, the impact of the bank on private sector investment is likely to be severely curtailed. This is, after all, the single most important role that a public bank can play.

The bank can enhance the credibility of current policies by offering a clear signal to the private sector. By tying in its own fortunes to the success of green investments, the public sector can show itself willing to cover some of the policy and regulatory risk under its control. The private sector is highly unlikely to take on policy risk it cannot control, if the public sector is unwilling to take on policy risk it can control.

The purpose of the Green Investment Bank is not to borrow to finance current spending, but to build up productive assets. A more consistent accruals approach to public accounting ought to assess its impact on public sector net worth through its investment in productive green assets.

The lessons from the UK can be applied globally. Governments across the world stand to gain through the creation of institutions that cover policy risk in markets which, for the most part, rely on policy action to be commercially viable. Together with market-based instruments, involving long term carbon pricing, standards and regulations and carefully designed technology support. This has the potential to unlock private investment in renewable energy, energy efficiency, smart connected technologies and low carbon vehicles. Most importantly, they would do so by utilising the record pool of available private saving.

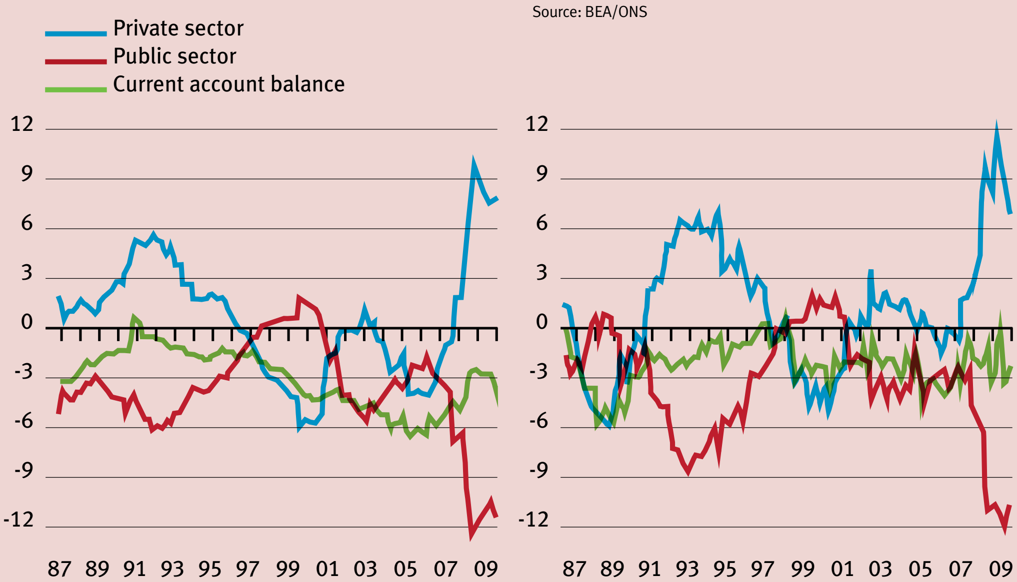
The opportunities afforded by current macroeconomic conditions should not be missed. In the UK and the US, the present excess of desired saving over desired investment has pushed real interest rates close to or below zero. The availability of underemployed human and capital resources offers policy-makers great

Figure 1: Sector financial balances, % of GDP

United States

United Kingdom

Source: BEA/ONS



potential to lever private investment into green markets productively.

Some of this saving stems from Asian countries running current account surpluses. For over a decade these flows have helped to raise the price of developed country assets and to keep interest rates low, playing a part in initiating the recent housing boom which underlay the financial crisis (see *Global imbalances: the perspective of the Bank of England* by Mervyn King, Banque de France, 2011). The G20 has long been committed to enhancing exchange rate flexibility to address such "persistently large imbalances".

But, since 2008, these flows have been swamped by a far larger wave of surplus saving, this time generated domestically in the developed world. After the financial crash, businesses and households in the rich countries have responded to falling asset values by spending less while saving more to pay down outstanding debt. The combined effect has been a massive surge in global liquidity – the cash, or assets that can be converted into cash quickly and without any price discount – available to fund investment (see *A macroeconomic plan for a green recovery* by Dimitri Zenghelis, LSE 2011).

> "the availability of underemployed human and capital resources offers policy-makers great potential to lever private investment into green markets productively"

Figure 1 above shows net borrowing – the balance between investment and saving or, equivalently, income and expenditure – for the private and public sectors. The current account aggregates both balances and measures the excess of saving over investment – income over spending – for the whole economy.

The private sector in the United States alone generated a record surplus of $4.8 trillion in 2009. By comparison worldwide investment in clean energy by both the public and private sectors totalled just $162 billion, according to a report by Pew Charitable Trusts.

This money, in many cases, has had nowhere productive to go as investors and banks remain insufficiently confident in future markets to extend lending. Consequently, short and long term interest real rates have fallen to near or below zero, despite billions of dollars of public sector borrowing.

This flood of liquidity creates a policy problem. Normally, when recession threatens, central banks respond by cutting short term policy rates to stimulate private spending. But when rates are close to zero, this vital mechanism is no longer available because no one will lend at negative rates.

The limitations of monetary policy have begun to be matched by limitations on fiscal policy. As private spending collapsed, so too did tax revenues, while welfare spending accelerated. Additional economic stimulus measures exacerbated the resulting deterioration in global public deficits. As a result, record private sector surpluses have been offset by record public sector deficits.

Had the public sector not borrowed to offset the reduction in private spending out of income, demand in the economy would have fallen further with dire consequences for output and jobs. But, accumulating public debt has raised questions about the ability and willingness of future taxpayers to pay it off.

The cost of such uncertainty has been a loss in investor confidence and much higher bond rates in vulnerable countries such as Greece, Ireland and Portugal, exacerbating debt servicing costs and further straining fiscal deficits.

A better approach might be for governments to create profitable private sector opportunities. Public intervention is required if the optimal level of green investment is to be attained, as there have been numerous market failures, stemming from the failure to cost the damage from pollution and greenhouse gas emissions, coupled with the lack of upfront incentives for energy efficiency and research, development and deployment investment.

Investors rely on policy-makers to define the nature and scope of such markets. If the government can send credible and transparent signals, in the form of clear, market-based policy instruments and appropriate shouldering of risk, it could unlock private investment in green technologies, utilising the vast pool of private saving. This would involve long term carbon pricing, standards and regulations, and carefully designed technology support.

By being open and non-discriminatory, such frameworks also reduce incentives for wasteful 'rent capture', ie monopoly profiteering by powerful industrial lobbies and other influential vested interests who are allocated grants, subsidies or contracts with limited competition by government. This would unleash sizeable macroeconomic benefits, by boosting private spending, creating jobs and generating tax revenues. With output remaining below capacity and the cost of capital historically low, there is very little fear of crowding out alternative investment, or displacing jobs.

There is no lack of private money in the current market. However, there is a perceived lack of opportunity. All that is required is for governments to grasp the green opportunity to unleash huge private investment and innovation opportunities. If governments fail to act, not only do they risk missing an opportunity to lock in to low carbon infrastructure, they also risk unnecessarily extending the present economic crisis.

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