Progressive Economics Group (PEG)
Policy Brief

Labour's National Investment Bank - a valuable initiative

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June 2018

Policy Issue

The private financial system on its own cannot perform well to support the real economy or implement a new industrial strategy. It does not fund sufficient long-term investment in risky innovation, neglects key sectors, including both physical and social infrastructure, and fails adequately to support small and medium sized enterprises. Therefore the National Investment Bank (NIB) will be a valuable instrument for a Labour (and other future)government to help achieve increased investment for making the UK economy more dynamic, greener and fairer.

What role could a National Investment Bank play in creating a better investment environment to support industrial policy?

Analysis

One of the many very valuable proposals in the Labour Manifesto is that of creating a National Investment Bank (NIB), to help the much needed funding of infrastructure, including green one and SMEs, particularly those linked to technological innovation. More broadly, the NIB would be a key instrument for helping implement and contribute sufficient financial resources for an industrial policy, to help re-balance the UK economy, mainly towards manufacturing and useful services, and help increase dynamism and productivity.

In the wake of the 2007/09 global financial crises, there emerged increased support world wide for national development banks, as the problems of a purely private financial sector became more evident. The private financial system on its own cannot perform well to support the real economy. It has been pro-cyclical, over-lending in boom times but rationing credit during and after crises. It has not sufficiently funded long-term investment in risky innovation, which businesses need to grow, and create high productivity jobs. Funding for key sectors, like infrastructure, both physical and social, have been neglected, especially at longer maturities. Small and medium sized enterprises have difficulty in accessing credit, which is prohibitively costly and short-term. The implication is that irrespective of policy orientation, the failure of private financial markets to deliver adequate real economy finance encourages most governments to rely on public development banking institutions.

National development banks have been an important feature of financial sectors of most developed and emerging economies, especially the most successful and dynamic ones, like Germany, China, India, South Korea, India and Japan. The UK has been an exception in not having such a public development bank, despite its evident need. Private and public investment have been historically low in the UK economy, and have fallen sharply since the beginning of the 2007/8 crisis, due in an important part to Conservative government imposed

austerity. The UK remains in last place amongst both G7 and OECD countries, with the lowest share of investment in GDP.

One important element in facilitating a development bank making an important contribution to industrial policy and structural transformation is sufficient scale. Here we can draw valuable lessons from Germany's KfW, given that it is the most successful and effective national development bank in Europe, and Germany is the most dynamic and diversified European economy. Indeed, with assets of over €500bn, the KfW is one of the world's largest development banks, when its size is measured as a percentage of GDP, and is one of Germany's largest banks.

The KfW approves new loans per annum of around € 50 - 55 billion for domestic purposes. As the population of the UK is around 80% of the German population, a comparable lending capacity for the UK would be around € 42 billion p.a., which is around £ 37 billion p.a. The total loan exposure of the KfW is around € 500 billion, which is approximately £ 440 billion. If we assume a similar scale for the UK, in proportion to its population, total exposure of the NIB should reach £ 350 billion, after a number of years.

In order to achieve this loan volume, assuming a leverage ratio of 1:9 (in order to achieve the best possible AAA rating), the NIB would require equity of around £ 40 bn, which would consist mainly of public paid-in capital. However, if the NIB has profits after lending commences, these could be reinvested into the bank as equity, enabling it to continue expanding lending volume, without the need for further public capital injections. This is what happens with institutions like KfW, or the European investment Bank (EIB). An ideal way forward, to achieve high levels of loans soon is to put significant capital upfront, for example £10 billion a year, for four years.

It is interesting that the German government guarantees to the KfW implied it was able even in the financial crisis after some losses to keep the AAA funding in place - showing an equity of € 11.7 billion only by comparison to around € 37 billion likely considered as necessary without such a guarantee. So the figures of the previous paragraphs, on potential size of capital for the NIB, could be reduced significantly - as a rule of thumb there could be a reduction to one half or up to one third, after a certain period of time, when the new institution has built up the confidence of the financial community (specifically bond investors).

An important point, arising also from the KfW experience, is that even though KfW loans have a general government guarantee, its' loans do not count towards the 3 percent public deficit to GDP ratio Maastricht target according to European statistical conventions. There is a very strong case to be made that in the UK, future loans made by the NIB should similarly not be counted as part of the government deficit target, nor towards public government debt. A clear economic rationale is the fact that these loans would be only channeled to investment, which will promote growth, so they may actually reduce, and certainly not increase future debt burdens, when debt is measured as % of GDP.

It is important to stress that though the UK NIB would be publicly owned, (as the government would provide initial paid-in capital), it could fund its operations on the national and international private capital markets. Furthermore, it could co-finance many of its operations with private lenders and investors. Finally, most of its funds would be on lent by private banks.

This implies that, like the German KfW and other development banks, the UK NIB would have very close collaboration, rather than competition, with the private financial and non-financial business sector. Also this has the virtue of leverage, as with relatively scarce public resources committed as paid-in capital, it could catalyze lending and investment on a far

larger scale than its public resources contribution. This leverage is very valuable, especially for a government committed to structural transformation of the UK economy, to make it more dynamic, greener and fairer, which requires significant investment. Development banks provide a very important instrument for implementing and helping fund such a transformation, especially in countries like the UK, where the investment rate is so low.

After the global financial crisis, European Union member states have increased the role of national development banks, and especially that of the European investment Bank (EIB). The EIB saw its paid-in capital doubled in 2012, and its role further increased by the Junker Plan, by which the EIB is planned to generate directly and indirectly, via leverage up to €500 billion of additional loans in the 2015-2020 period. One of the important mechanisms for leverage of the Junker plan is for the EIB to collaborate closely with national development banks.

For this and other reasons, like that the EIB has great expertise in lending to key infrastructure projects, and for support of SMEs, including through venture capital, the EIB would seem to be an ideal partner for the future UK NIB, complementing and supporting its activities. So if the UK does leave the European Union, it would seem very important for it to ideally remain a full member of the EIB if possible, and if not possible, at least to have as close an association with it as feasible. This would be ideal to help the NIB benefit from all the EIB accumulated expertise, as well as its' financial resources, for co-financing key activities.

Policy Framework

The National Investment Bank (NIB) will be a valuable instrument for a Labour government (and other future governments) to help achieve increased investment for making the UK economy more dynamic, greener and fairer.

International experience and the limitations of a purely financial sector confirm the great value of such a bank for the UK.

It is key that the NIB has sufficient scale to fulfill its valuable roles well.

Funding itself in the UK and international private capital markets will allow the NIB to leverage scarce public resources, leading to large impact.

The impact of the NIB could be further significantly enhanced if the UK could remain in the European Investment Bank.

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