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Speech

The case for a National Investment Bank

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This is a transcript of Professor Stephany Griffith-Jones's address from her joint lecture with John McDonnell MP on the case for a UK national investment bank, part of PEF's series of public lectures on macroeconomic issues. More information and a video recording of the lecture can be found on the events section of our website.

The views expressed here are those of the author, and not necessarily those of the Progressive Economy Forum.

I am very grateful for the opportunity to make the case for the value of a diversified financial system, and specifically one which includes a public national investment bank, as Labour proposes to create. My presentation will draw on the analysis and conclusions of my recently published OUP book, *The Future of National Development Banks*, which I co-edited with José Antonio Ocampo. This event is in the context of the Progressive Economy Forum series. I want to particularly thank Patrick Allen for chairing and supporting this launch, as well as the PEF Council, and Michael Davies for all the backing. I am extremely grateful and really delighted that John McDonnell will so kindly speak at tonight's event on the role of a national investment bank in Labour's economic strategy. Many thanks also to John Weeks and Josh Ryan Collins for joining the panel.

One of the many very valuable proposals in the Labour Manifesto is that of creating a National Investment Bank (NIB), to help provide much needed funding for investment in infrastructure, including green infrastructure, and for small and medium enterprises (SMEs), particularly those more likely to innovate and grow. More broadly, the NIB would be a key instrument for helping implement and contribute sufficient financial resources for an industrial policy. It would increase lending and investing in sectors that are key for the UK's structural transformation to an ecologically sustainable economy, help increase productivity, and contribute to the higher growth of wages and living standards for the majority of people.

In the wake of the 2007-09 Global Financial Crisis, support for National Investment Banks, as well as for Multilateral Development Banks, grew worldwide. A basic reason is that the private financial system is pro-cyclical, lending too much in booms, and rationing credit during crises and their aftermath. Furthermore, the private financial sector is often incapable, on its own, of providing adequate finance at sufficient maturity and reasonable cost to small firms, and of delivering sufficient funding for new innovative companies, infrastructure and sustainable development projects. More broadly, it insufficiently supports the investment required for transformation towards more dynamic, inclusive and sustainable economies. The key reason is that private finance, on its own, is often unwilling to fund activities with uncertain returns, such as investment in new sectors or new technologies, and in projects with environmental and other externalities, such as renewable energy, often key for structural transformation and sustainable development.

The failure of private financial markets to deliver adequate funding in a stable and appropriate manner prompted many governments to rely more on national investment banks. They are and have been an important feature of financial sectors of most developed and middle-income countries, especially the most successful ones - like Germany, Japan, Canada, France, India, China and South Korea. A number of European countries (like Portugal, Ireland, and Scotland) recently created new NIBs, whilst others expanded existing ones, like BPI France.

In *The Future of National Development Banks*, co-edited with José Antonio Ocampo, we analyze NIBs (or NDBs) in seven countries and conclude that overall these banks tend to be broadly very successful at what they do. They have been very efficient development policy instruments in the various countries studied, helping overcome major market failures, and do so in a flexible way over time. Most crucially, they have played important roles in helping to fund national development strategies, and to facilitate structural transformation to more dynamic, higher productivity, greener and more inclusive economies. They do this in close collaboration with the private sector, both financial and non-financial.

NDBs have been innovative in several aspects. They have gone into new activities, supporting innovation and entrepreneurship. For example China's CDB, Germany's KfW and Brazil's BNDES have supported technological innovation; others like France's BPI and Chile's CORFO have supported entrepreneurship, as well as innovation.

NDBs played an important role supporting key new sectors, like renewable energy and energy efficiency, crucial for delivering a livable future to all people on the planet. For example, Germany's KfW was initially the sole lender to private companies investing in solar energy in Germany; later private banks followed. In China, the development bank CDB both helped design broad policy to encourage investment in renewables, especially solar, and played a major role in initial funding. Germany and especially China have thus been major actors in promoting the spread of solar energy worldwide, at increasingly competitive cost with fossil fuel energy. Their NDBs played a major role in catalyzing this key development, so essential for mitigating climate change. NDBs have also developed new instruments, such as guarantees, equity (including venture capital) and debt funds, as well as new instruments for funding SMEs.

The UK has been a lone exception amongst G7 European countries in not having such a public development or investment 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 austerity imposed by Conservative governments. The UK remains in last place amongst both G7 and OECD countries, with the lowest share of investment in GDP in the period 1997 to 2017.

It seems essential for the UK to have a national investment bank, along the lines of what the Labour Party is proposing, which builds on international experience. This will help fund the investment needed to support the structural transformation required for a greener economy, that will provide our citizens with an ecologically sustainable future and decent jobs, and will increase the UK's productivity throughout the country; above all, it can help create an economy that serves the many not the few. It would help implement and contribute sufficient financial resources to a modern industrial policy that re-balances the UK economy, between sectors and between regions, and contributes to delivering a viable ecosystem nationally and internationally.

National investment banks have paid-in capital provided by governments, but raise long-term funds on national and international private capital markets to fund their long-term loans. Often, their loans are co-financed by private commercial banks or equity investors. Leveraging public resources with private ones has been especially valued in context of fairly limited fiscal space, allowing Governments to have large and transformative economic impact with relatively limited public resources.

National investment banks mainly lend to, or invest in, private companies. 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. It is important to emphasize that national investment banks can also provide loans and equity to public entities or cooperatives.

National investment banks help compensate for declines in or slower growth of private credit during economic downturns, thus providing essential funding to maintain essential investment in bad times and reducing the magnitude of any downturn. There is clear evidence from the World Bank that national development banks in all countries provided such valuable counter-cyclical lending in the aftermath of the 2007-09 global financial crisis, as lending worldwide by national investment banks increased by 36% during those two years.

One important element in facilitating a development bank to make an important contribution to structural transformation is sufficient scale. Here we can draw valuable lessons from several national investment banks we have studied, such as Germany's KfW. KfW is seen as one of the most successful and effective national development banks 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 national GDP, and is one of Germany's largest commercial 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 long-term 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, approximately £440 billion. If we assume a similar scale for the UK, in proportion to its population, the total exposure of its NIB should reach £350 billion, after around 15-20 years.

To achieve this loan volume, assuming a leverage ratio of 1:9 (to obtain the best possible rating), the NIB would require equity of around £40bn 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). Furthermore, if the Government provides a guarantee to the NIB, the total required paid-in capital may be lower.

Significant scale initially of the NIB is very important, so it can have a meaningful impact in helping to fulfil the industrial strategy and other aims of a Labour government, such as the urgent tasks of distributing growth more evenly and fairly in different regions and ensuring ecological sustainability. On the other hand, operations may need to be increased relatively gradually, to ensure high quality lending as well as equity investment. Indeed, banks like the European Investment Bank grew fairly slowly initially, and then expanded far more rapidly, mainly for this reason.

The National Investment Bank will already be capitalised at small scale, using the British Business Bank entity as the corporate vehicle. It will use key parts of the British Business Bank's SME lending and equity finance. Further significant paid-in capital will be needed in year one to back infrastructure project finance and increase availability of funds for expanding SME operations, as argued in our forthcoming paper Griffith-Jones, Harris and Rice. It may be desirable in year one to increase equity capital by say £5 billion with further equity capital injections of up to £25 billion, so as to be able to fulfil the target of total stock of lending of £250 billion after 10 years, which Labour has defined in its manifesto. Indeed, in the longer term, a Labour government may wish the NIB to be even bigger, if it wishes it to be on the same scale (per capita) as the German KfW, as discussed above. This would require a total paid-in capital of up to £40 billion.

Both the international experience, and – especially - the needs of the UK economy seem to point to the NIB to focus on two main sectors:

1. Addressing the long-term funding gap for small- and medium-sized enterprises (SMEs) across the country, with particular emphasis on innovation, sustainability and growth. Digitalization may initially be an important part of 'innovation'. This could be applied in a way that gives priority to SMEs in areas of socio-economic deprivation, where private funding has been especially insufficient. The regional structure of the NIB should contribute to realizing this aim.

2. Addressing the long-term funding gap for infrastructure investment across the country, including both physical and social infrastructure. Special emphasis would be placed on infrastructure that is low carbon, as for example infrastructure producing renewable energy, infrastructure for public transport, as well as for low carbon vehicles (such as electrical ones). This would contribute to the essential task of helping make investment consistent with the limits of the planet, as clearly presented in Green New Deal proposals. As in other countries, the NIB would work closely with government spending on infrastructure. In the UK case, Labour is proposing to create a National Transformation Fund, which would invest £250 billion over 10 years; that Fund will work closely with the National Investment Bank on funding infrastructure.

The National Investment Bank will need to generate additional channels of transmission of lending to SMEs. Direct funding (also called first tier lending) seems to be the preferred model in light of the UK experience till now. It has the advantage of supporting directly the aims of the Bank and of broad government policy, e.g. greening the economy. Direct funding will also allow for support to be directed rapidly to the economy when there are cyclical downturns and banks are restoring their balance sheets. This can mainly be achieved by a new regional banking infrastructure to ensure local presence of the NIB for small and medium enterprise firms. French BPI provides a valuable precedent for how this can be done successfully.

Complementary indirect funding channels could be through existing commercial banks. Access to such funds should be for new lending in accordance with appropriate guidelines that could be agreed between the NIB and any bank participant. Conditionalities should be used to direct banks to support investment in the productive sector of the economy, in line with the Governments' overall industrial strategy direction.

There is evidence that where SMEs borrow more from state-owned banks relative to private banks, financial constraints are reduced for SMEs without a corresponding increase in default risk. This research attributes that successful result to the value of "private and soft information on borrower quality", "consistent with relationship lending". This is consistent with the theoretical insight from Joseph Stiglitz, linked to reducing asymmetries of information, given that regional branches of the NIB could acquire detailed knowledge of sectors and companies.

The NIB would thus need a regional branch network to truly be effective in the support of SMEs. The regional NIB branches will need to establish connections to communities and local businesses to more fully understand SME clients and risk. This points to the need for a National Investment Bank to develop relationship lending, so that soft information can be well gathered. The National Investment Bank should be a source of expertise, as well as a source of funds. Naturally, due consideration must be given to not expand too much NIB overhead costs, so that their increase is smaller than the potential gains achieved by the increase in relationship lending, and greater knowledge achieved.

A key lesson we can learn from international experience is the need to have a “good” investment bank. Good governance is very central to achieving this, including transparency and accountability. A good investment bank has to respond to government’s broad priorities, and work closely with the private sector, but must be independent of narrow vested interests in both, so as not to be captured by them.

Having an NIB Board, which has skills in business and management, banking and risk, as well as technical knowledge of infrastructure and SME investment, would help ensure good governance. The presence on the Board of senior public sector representatives (involved in designing government strategy) as well as trade union representatives and representatives from SMEs and consumer groups would further contribute valuable perspectives.

It is key that the NIB staff should have great engineering and/or scientific expertise, and not just financial skills. There should be no staff oriented towards quantitative financial engineering, other than for risk management purposes. The bank will have a clear mandate to focus on SMEs and infrastructure investments, and will by definition do no speculative investing. Instead the focus should be on real engineering, entrepreneurial and scientific skills to help deliver the NIB mandate.

To support its broad mandate, the NIB will need to develop significant in-house expertise. As the work of Macfarlane and Mazzucato shows, a key difference between successful NIBs and private financial institutions is the breadth of expertise and capacities contained within staff. In many cases, such as KfW, BPI France and the European Investment Bank (EIB), this includes not only financial expertise but also significant in-house engineering and scientific knowledge about the sectors the bank is active in and the nature of the investments being made. This enables investment decisions to be based on a wider set of criteria than relying on market signals alone (though these are important) and means they are better placed to appraise social and environmental considerations.

In fact, in its initial recruitment, the UK NIB could benefit from attracting current or former staff of institutions like KfW, BPI, EIB, and indeed the UK Green Investment Bank: some of these staff could come on a temporary (loan) basis, whilst others could be attracted more permanently.

This in-house interdisciplinary expertise amongst NIB staff will make it easier to develop an investment culture mainly focussed on achieving positive, dynamic real economy outcomes in the UK NIB. The bank should be profit-making but not profit-maximizing. Indeed a national investment (or development) bank has both to fulfil the mandate of serving an ecologically sustainable as well as inclusive real economy, and of making reasonable profits - these will fund expansion of the bank, so it can increasingly play its important role.