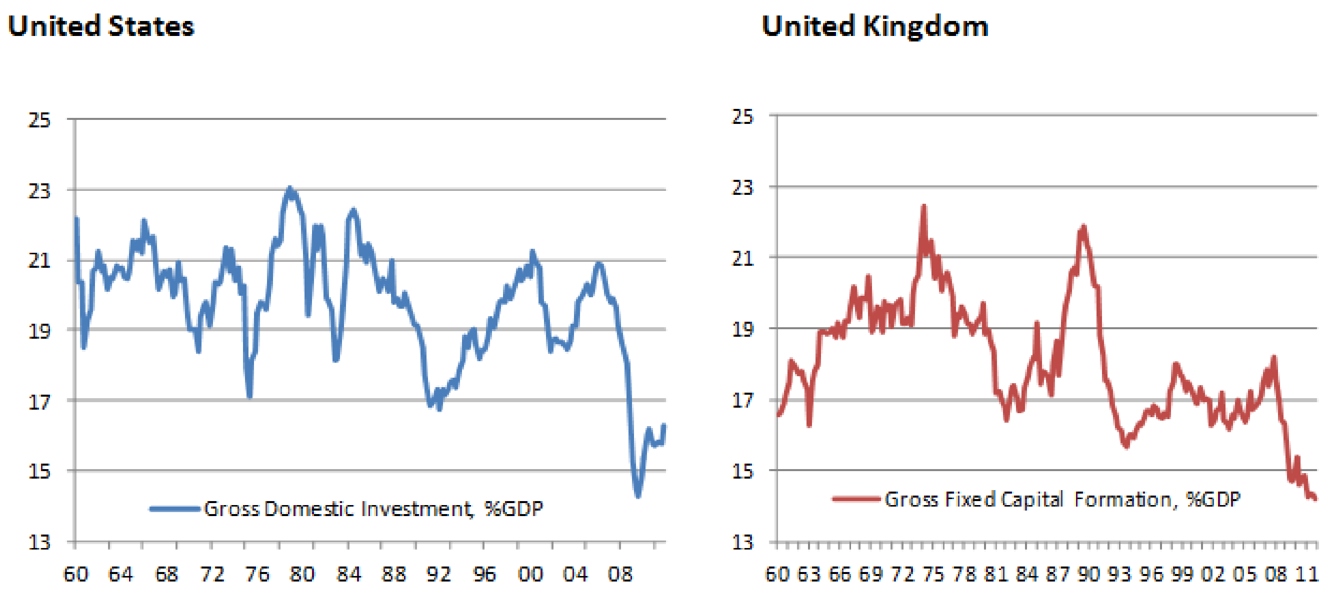
Restoring growth and confidence through resource-efficient innovation

Dimitri Zenghelis *argues that the government can help stimulate growth by recognising the inevitable transition to a low-carbon economy. This could provide new business opportunities for investors while tapping into a fast-growing global market for resource-efficient activities.*

The UK faces the prospect of a protracted recession even before output has fully made up the losses from the last recession, with GDP yet to return to its 2008 peak. Yet the current period of low confidence presents a golden opportunity for UK to boost employment and stimulate economic growth, while encouraging competition and innovation.

Growth requires investment, yet investment has slumped to record lows in most rich countries mainly because households, businesses and banks are nervous about future demand, and have responded by forgoing more risky investment in physical capital.

Figure 1: Fixed investment

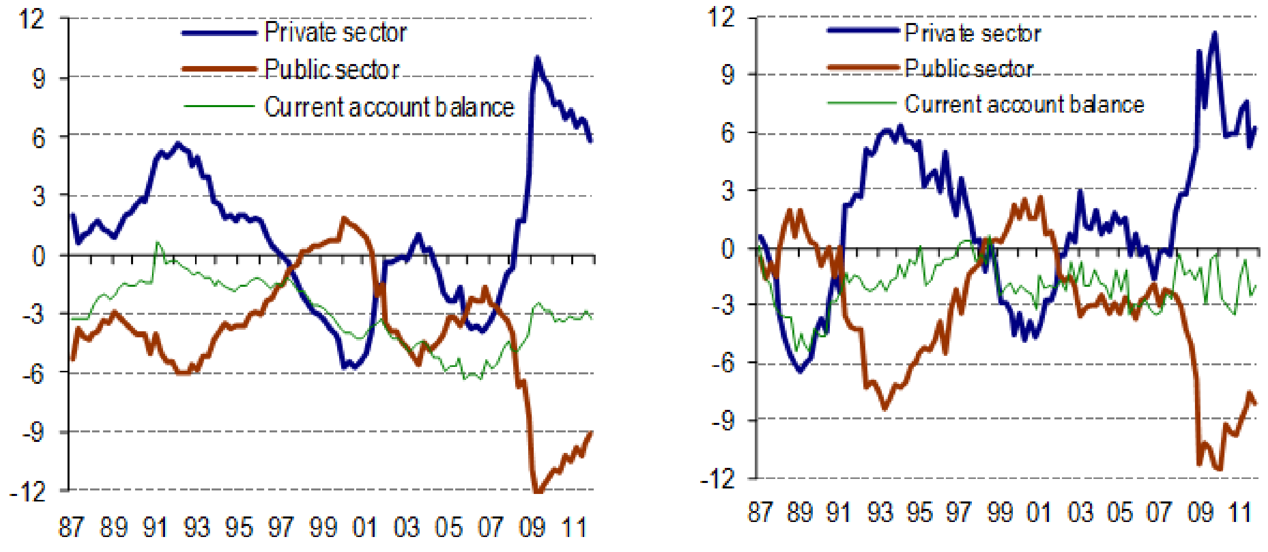


Source: Bureau of Economic Analysis/Office of National Statistics, quarterly data to fourth quarter of 2011.

Instead, companies and households are squirreling private saving into 'risk-free' assets such as solvent sovereign bonds. As a result, annual private sector surpluses over the past few years have been at record levels, and amounted to £99 billion last year, equivalent to 6 per cent of UK GDP.

Figure 2: Sector financial balances (net lending)

United States | **United Kingdom**



Source: Bureau of Economic Analysis/Office of National Statistics, data to fourth quarter of 2011.

After the financial crash, households, businesses and banks undertook necessary and unavoidable long-run stock readjustment in balance sheets. But we are now witnessing a classic 'paradox of thrift', in which pessimism over the short term outlook prompts households, businesses, banks and now government to cut investment, shed labour, restrict credit and store money. But when everyone retrenches simultaneously, fear of recession becomes a self-fulfilling prophecy yielding a vicious circle of low demand and low investment.

Desired saving has exceeded desired investment in many advanced economies to such a degree that global real 'risk-free' interest rates for the next 20 years have been pushed below zero. Savings are losing value by the day as pension funds and financial institutions pay real interest to (rather than receive interest from) solvent governments; a truly perverse state of affairs given the need for productive investment. These low rates do not reflect a collapse in the underlying returns to capital; instead they reflect desperately depleted confidence.

Table 1. Daily United States Treasury yield curve rates

Date	1 month	3 month	6 month	1 year	2 year	3 year	5 year	7 year	10 year	20 year
1 June 2012	0.03	0.07	0.12	0.17	0.25	0.34	0.62	0.93	1.47	2.13

Source: United States Treasury

What is needed to restore confidence is a clear strategic vision with supporting policies to guide investors and capture businesses imagination. In the past, governments have got out of such recessions through setting new challenges such as rearmament, electrification, space-races and Roosevelt's New Deal. Today, policies which recognise the inevitable transition to a low-carbon economy could provide new business opportunities for investors while tapping into a fast-growing global market for resource-efficient activities. As well as leaving a lasting legacy in delivering energy security, tackling climate change, and saving consumers and businesses costs in the long run, these sectors offer long-term returns for investors. The necessary change will be massive and transformative. It will require major investment in all regions of world across all economic sectors including buildings, transportation, agriculture, manufacturing and communications.

The best time to support investment is during a protracted economic slowdown. Resource costs are low and the potential to crowd out alternative investment and employment is small. The most recent figures published by the Department for Business, Innovation and Skills show that the UK low-carbon and environmental goods and services sector had sales of £116.8 billion in 2009-10, growing 4.3 per cent from the previous year and placing the UK sixth in the global league table. But the private sector is not investing as heavily as it could in green innovation and infrastructure because of a lack of confidence in future returns in this policy-driven sector due to uncertainties surrounding current energy and environment policy.

Cautious investors can be driven to act now by correctly priced public resources, sweeping standards, regulations and technology support without relying on private sector sentiment to drive demand. South Korea and China have understood the logic of this approach. They recognise that investment flows to the pioneers of the revolutions and have provided strong policy support for energy efficacy, renewable technologies and electric vehicles.

The expenditure involved in making the transition to a resource-efficient economy must be assessed as an investment and not a mere resource cost. It is also important to understand the full dynamic economic costs, benefits and risks including the cost-savings from induced innovation.

The reliance on policy to drive this market has advantages in the current fragile economic environment. Only the Government can limit policy risk. Thus, by backing its own green policies, the Government can stimulate additional net private sector investment, and make a significant contribution to economic growth and employment. It can do this, for instance, by allowing a well-capitalised Green Investment Bank to operate as a lending institution, sharing some of the risk of private investments in green infrastructure. The UK should also work with European Union to increase the target for emissions reductions for 2020 to 30 per cent from 20 per cent, supporting the carbon price within the Emissions Trading System.

Promoting future growth also requires policies to shift the tax base away from intellectual activity and towards materials and resources. Finally, conveying the false impression that there is a choice between resource efficiency and economic growth undermines private sector confidence and needlessly raises the risk premium on such investment. Loose talk costs jobs. There is no lack of private money, just a perceived lack of opportunity. This window of opportunity should not be wasted.

Note: This article gives the views of the author, and not the position of the British Politics and Policy blog, nor of the London School of Economics. Please read our comments policy before posting.

About the author

Dimitri Zenghelis *is a Senior Visiting Fellow at the Grantham Research Institute on Climate Change London School of Economics, Associate Fellow Royal Institute of International Affairs at Chatham House and Senior Economic Adviser Cisco.*

You may also be interested in the following posts (automatically generated):

1. The current jobs crisis is the result of a lack of business confidence and a shortage of consumers with money to spend. The government needs to create a long-term framework to drive innovation and raise productivity across the economy (26.7)
2. We need to focus on growth and being greener – not 'green growth' (18.9)
3. Who ate all the economic pie? Exploring the myth and reality of decoupling wage growth and productivity growth (17.8)
4. Low-carbon innovation is up, but not because of the EU Emissions Trading Scheme (15.7)