ace

consultancy engineering business environment

Infrastructure Gilts

Quantitatively easing the UK's infrastructure deficit.
An ACE conversation starter

Adam Patterson

December 2009

Association for Consultancy and Engineering Alliance House 12 Caxton Street London SW1H 0QL
T: 020 7222 6557 **F:** 020 7990 9202 consult@acenet.co.uk www.acenet.co.uk

The Association is Registered as a company in England with the number 132142, it is limited by guarantee and has its registered office at the above address

ACE suggests

- Using any future quantitative easing to fund investment in the UK's infrastructure network, this could provide an efficient medium term fiscal boost and enhance the future trajectory of economic growth;
- The Bank of England could use some of the asset purchases (the current programme is expected to be completed by February 2010) to buy corporate bonds of those firms investing in UK infrastructure assets to indirectly fund infrastructure requirements or to banks to fund such projects directly;
- Even if quantitative easing is not extended, government gilts issued by the Debt Management Office could be ring fenced and directed into critical capital projects. The government is set to borrow £178 billion this fiscal year and yet sell £225 billion in bonds. Part of this 'capital gap' could be employed for infrastructure investment.

Quantitative infrastructure – easing

With the economy still struggling to grow in the fourth quarter and the broad money supply still under pressure the Ban of England (BoE) may decide to extend it's quantitative easing (QE) over the next few months to further support the economy and avoid deflation. This is especially likely in February 2010 when the current programme of asset purchases runs out and the bank will benefit from a new set of inflation projections. QE could then be used to prop up the economy should it relapse in early 2010.

Although stimulating the economy and lending in the short term is paramount, there is a broader opportunity to tackle a £500 billion infrastructure crunch over the next decade which could constrain the UK's ability to compete in the global economy.

If asset purchases are indeed continued the bank could earmark some of the electronic money to corporate bonds of those firms investing in the UK's infrastructure assets – indirectly funding UK infrastructure and keeping borrowing costs low – or to banks to shore up capital ratios in return for guarantees that when the market stabilises it uses these securities to fund infrastructure projects in the UK.

Furthermore, the bank could purchase specific government bonds used exclusively for capital and not current public spending in a similar way to the Build America Bonds in the United States and infrastructure banks around the world. Targeting asset purchases in this way using 'infrastructure gilts' will ensure that the government is able to tackle the infrastructure deficit whilst at the same time enhancing aggregate demand in the economy and thus ensuring a 'dual dividend'.

Even if QE is not extended, government gilts issued by the Debt Management Office could also be ring fenced for the productive capital expenditure on energy and transport infrastructure will help boost the sustainable rate of future growth. On the 9th December 2009 the DMO announced the issuance of £225 billion of bonds for the financial year to the end of March 2010 (a new record). Although the majority of funds will be used for plugging fiscal gaps, the importance of infrastructure assets – recognised by the chancellor in the December Pre-Budget Report – should necessitate directing funds raised to critical capital projects.

Investing in the UK's transport, energy and social infrastructure would then provide an extensive fiscal stimulus over the medium term and give a much needed boost to investor confidence levels. Moreover such a move would send out a signal that the authorities are seriously looking at providing solutions to the UK's structural challenges.

Some economists have criticised the BoE's open market programme for not feeding through into the wider economy, but with such a pronounced multiplier that construction spending brings – some estimate this to be a factor of 10 – helping direct funds into the provision of infrastructure assets would be a sure fire way of pumping demand into the economy as well as keeping yields down (and thus borrowing costs low) and generating tax for a squeezed public purse. As the authorities look to scaling back the size of the big UK banks in order to reduce risky behaviour, infrastructure investment can provide a stable long term return.

This could be a perfect opportunity to help the recovery and send out a signal that when the recessionary dust fades UK Plc is committed to a world class infrastructure system on which future growth will be built.

How Infrastructure Gilts would work

The Bank could purchase specific government bonds used exclusively for capital and not current public spending in a similar way to the Build America Bonds in the United States and infrastructure banks around the world. Targeting asset purchases in this way using 'infrastructure gilts' will ensure that the government is able to tackle the infrastructure deficit whilst at the same time enhancing aggregate demand in the economy and thus ensuring a 'dual dividend'.

Even if QE is not used to explicitly fund infrastructure gilts, the bonds issued by the DMO can still be directed into capital projects. The bonds would just be financed through the wholesale markets to private and institutional investors. They would be attractive because of a stable yield whilst the government receives the funds it desperately needs to finance the national infrastructure deficit.

Investing in the UK's transport, energy and social infrastructure would then provide an extensive fiscal stimulus over the medium term and give a much needed boost to investor confidence levels. Moreover, such a move would send out a signal that the authorities are seriously looking at providing solutions to the UK's structural challenges.

Infrastructure deficit

The £500 billion deficit is based on a report by Policy Exchange: 'Delivering a 21st century infrastructure for Britain'.

Frequently Asked Questions

1. How does the construction multiplier compare to other sectors?

According to the CBI the short term multiplier for construction spending is one of the most effective sectors in which the government could invest to stimulate economic activity in front of banking and finance, public administration and education. ONS estimates the construction output Type 1 multiplier at 2.09 with added type 2 benefits from manufacturing, transportation and tax generation

totalling £2.84. Construction has one of the highest output multipliers among sectors in which the government plays a key role.

2. Is the infrastructure gilt issuance to be on top of or part of existing govt borrowing plans?

Although infrastructure is of critical importance to the future of UK plc, government infrastructure gilts could be part of the Bank of England's Quantitative Easing programme or the DMO's bond issuance. The government needs to prioritise infrastructure as an effective medium term fiscal and indeed economic boost. Government borrowing is set to hit £178 billion this fiscal year and yet gilt sales will reach £225 billion. Ergo, part of this 'capital gap' could be employed for capital expenditure.

3. Will the corporate bonds issued by private developers need some sort of Government guarantee?

Infrastructure assets can provide stable long term yield and can be economically viable without an explicit government guarantee. Successful examples in the market place include Macquarie Infrastructure Group transport investment funds that are financed through the wholesale markets and operated in the private sector.

4. How does this proposal fit with an infrastructure bank?

ACE along with the ICE and Policy Exchange have both proposed the creation of an infrastructure bank. The creation of 'infrastructure gilts' is one mechanism that such a bank could use to increase investment from the public and private

levels. However, one can also create gilts designated for infrastructure without formally establishing such a bank.

For further information please contact:

Adam Patterson
Economic Analyst
apatterson@acenet.co.uk
020 7227 1882

Simon Goldie
Director, Policy and External Affairs
sgoldie@acenet.co.uk
020 7227 6557