September 16, 2016

A green solution to a grey growth outlook

Time for governments to show their commitment

A fortunate combination of circumstances, including historically low interest rates and an inflection point in sentiment towards climate change, is presenting governments with an opportunity to stimulate their ailing economies while repositioning their countries for a cleaner and more productive future.

Current stimulus measures are not working

In a world bereft of growth, where most central banks continually miss their inflation targets, there is an acceptance that stimulus measures are not working as hoped. It has been left to the central banks and monetary policy to generate a wealth effect and discourage saving in a bid to promote investment and growth. Unfortunately, this has in part increased wealth inequality, while negative interest rates have had unintended consequences for both the banking sector and the savings industry. Something has to change.

Fiscal initiatives are needed to bolster growth

There is growing acknowledgement that a coordinated and integrated approach to both monetary and fiscal policy is required to lift activity and prosperity to a higher and more self-sustaining level. Fiscal rectitude is of course required, but during times of growth and prosperity, not when economies are growing below their potential, with large output gaps. Over the past few years, austerity has simply not worked. The trouble is that government debt levels are high and rising, and there is fear of a political backlash if fiscal initiatives are enacted. Japan tried the austerity approach back in the 1990s, increasing taxes and cutting spending in a bid to reduce the debt load, only to discover that growth and subsequently tax receipts fell, while social security payments increased, resulting in higher, not lower, debt to GDP.

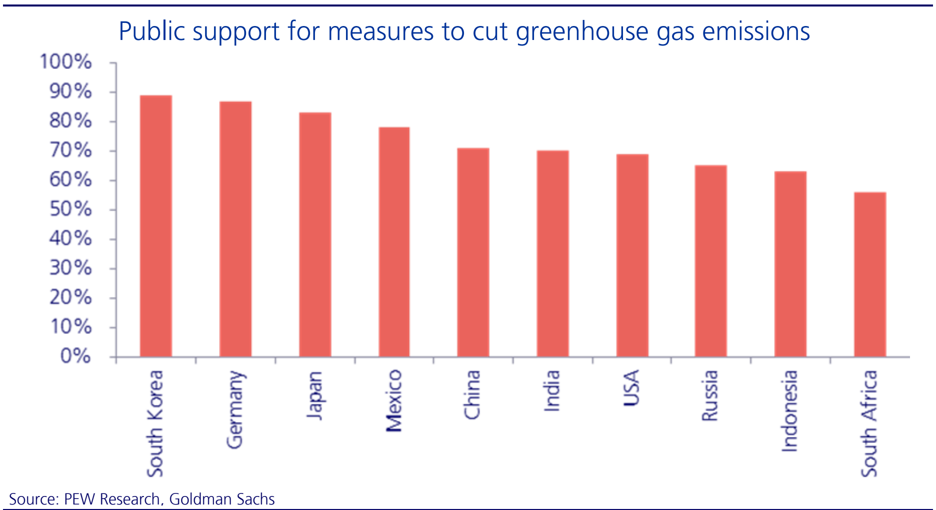
Unprecedented funding costs should be capitalised upon

With double-digit levels of returns on capital available in many developed regions (this is not Japan of the 1990s), governments need to think of spending as an investment in the future and a way to help catalyse commitments from the private sector. Large economies, particularly those running a surplus, should certainly be taking advantage of low or even negative long-term interest rates to improve their productivity and competitive position in the longer term. There is still a stigma, however, to initiating such spending. One way around this is to use the changing public and business perception of climate change and green initiatives to legitimise the need for fiscal investment. COP21, the landmark climate change agreement reached in Paris last year, seems to have been a seminal moment marking an inflection point in opinion. China and the US are the latest countries to agree to keeping global warming below 2 degrees centigrade of pre-industrial levels. For this to be achieved, massive investment will be required on a global scale, both in terms of mitigating and adapting to the changing environment.

Green bonds are proliferating as investors embrace the concept

Green bonds have come to the fore in recent years, offering investors the chance of profitable investments while doing good. In their basic form, raising money that will be dedicated to a particular cause while the investment is

msme@zurich.com



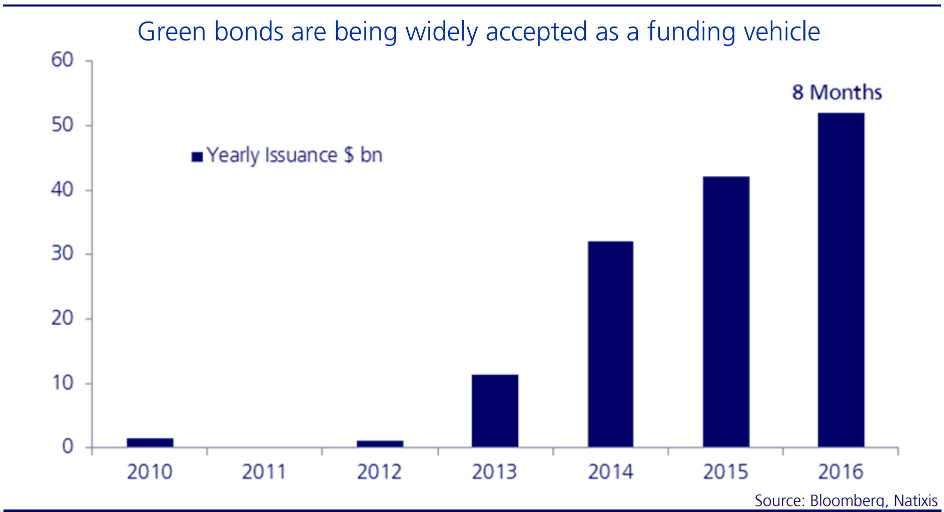
underwritten by the credit worthiness of the issuer itself, has been a great success. Supranationals, such as the EIB, and corporates are leading the move, representing 23% and 27% respectively of outstanding issuance, with banks and agencies making up the bulk of the remainder. However, the concept of green bonds should be seen as a template for governments to follow, offering another vehicle to raise funds.

Governments should capture a unique opportunity

Currently, legislation in many regions prohibits the ring-fencing of funds for a specific use, but this can and should be changed. To us, there appears to be numerous benefits in doing so: governments could raise socially acceptable funding for long-term investments, such as decarbonisation or adaptation initiatives to climate change. This could be particularly appropriate for projects that don't have a steady and predictable cash-flow stream, such as costal erosion or flood protection, and are not ideally suited to private sector investment. The electorate would see that spending is on dedicated projects where the funding is ring-fenced and fully accounted for. The governments themselves would be seen as taking a leading role in repositioning their country's future and competitiveness, while institutional investors would have access to currently scarce long duration assets to help manage their liabilities. Green bond financing would offer funding that could bridge election cycles and be dedicated to initiatives over decades. France appears to be taking the lead on this, with President Hollande announcing a government green bond issue next year, the first of its kind, and including the concept as part of France's annual financing bill. Hopefully, this will encourage more countries to do the same. Governments have a unique opportunity to take advantage of the lowest possible funding costs to embark on projects that will need to be undertaken at some point in the future anyway. By initiating these projects now they can stimulate economic activity and entice private investment flows. Over time, as growth picks up and inflation starts to rise, bond yields would also move away from their current supressed levels.

The future needs to be reshaped

Younger generations are likely to look back at the current negative interest rate environment and be baffled as to why those rates were not used constructively to invest for the future at a time where that future was uncertain precisely because of low growth and a lack of investment. While a green initiative will clearly not in itself provide a sea change for global growth, it could stimulate a more proactive fiscal initiative that is currently missing. Central bank asset purchases and monetary policy cannot be the only approach to break free from the legacy of the great financial crisis. Now is the time for governments to show their worth and commitment to positive growth initiatives and a greener future. With investors such as large pension funds and insurance companies scrambling to find high quality long-duration assets to invest in, and sentiment moving towards safeguarding the environment for future generations, a silver lining to a dark cloud is now presenting itself.



173001631 (01/16) TCL

ZURICH