Getting the financial system working efficiently again is essential for kick-starting the economy

blogs.lse.ac.uk/politicsandpolicy/getting-the-financial-system-working-efficiently-again-is-essential-for-kick-starting-the-economy/

3/21/2013

In response to yesterday's downward revision of growth expectations , **Hiba Sameen** *argues that growth is most likely to come from precisely those start-ups and new SMEs that are currently struggling to access finance. Unless the Government can get the financial system working effectively, so as to allocate capital in a manner which facilitates innovation, it is unlikely that the 'aspiration nation' will come into being.*

Once again the Budget has failed to deliver any prospect of a recovery or restoration of the path to growth. The Chancellor's deficit reduction policy appears to be failing in its own terms – there has been no significant fall in the deficit since 2010/11. The Office of Budget Responsibility has also had to revise down growth expectations for the economy for the current year from 1.2% to 0.6%, although once again it has maintained its resolute optimism on longer term growth prospects, forecasting a return to trend growth within the next two years. So, deficit reduction is stalling and there is little prospect for a full recovery in the coming years. Restoring growth must be at the heart of all of the Chancellor's plans – it is essential for jobs and wellbeing, as well as the fiscal consolidation plans.

One of the central barriers to restoring growth is that even five years after the financial crisis, our financial system remains dysfunctional and is manifestly failing to allocate capital to the right firms. The financial system promotes economic growth through the quality of capital allocation and not the overall rate of investment. It is inaccurate to view finance as a sort of plumbing system, whereby pouring credit in one end yields growth at the other. Rather, it functions as an economy's central nervous system, choosing where to allocate resources; hence a functional financial system is essential for economic growth.

The financial crisis also appears to have permanently scarred Britain's productivity through inefficient allocation of capital. Owing to historically low interest rates and banking bailouts in the aftermath of the crisis, struggling companies (aka 'zombie firms') can just about afford the interest payments on their loans, but not much more. There are zombie households, too – particularly those on interest-only mortgages who are unable to pay off the loan itself. Banks are holding a lot of unsustainable debt on their balance sheet and are thus unwilling or unable to lend to new innovative firms and start-ups with high-growth potential.

So, with growth increasingly unlikely and elusive, where should we now be looking? The answer is that growth and jobs are most likely to come from innovative new SMEs and start-ups that are currently struggling to access finance. Indeed, most firms report access to finance as one of the key obstacles to their growth (along with leadership and management skills). One potential hope is for alternative sources of lending to step in to plug the gap left by conventional bank lending. There is also the potential to develop new markets for lending – projects that were previously considered unviable could become viable with the introduction of new lending technologies and risk management techniques. With one government-commissioned report estimating the lending/funding gap for small businesses at between £26bn and £59bn over five years, there is a real opportunity for new forms of finance to grow rapidly to fill the gap. If realised, the returns for both businesses and the economy as a whole could be considerable.

Alternative finance represents a new, nimble ecosystem for small business finance, offering growing SMEs options as to how they fund their business. Last year saw nearly £250 million channelled through alternative finance platforms, and this stands to grow substantially in 2013 and beyond. Building on existing work in this area , the Big Innovation Centre recently released a provocation piece for another type of business debt finance – a 'Flexible Project Investment'. An FPI is a series of project-based bonds, released to match the cash flow profile of a project.

There was little in the way of big announcements in today's Budget, but there were indications that the government has been looking at some of the right areas to unlock growth. One notable announcement, missing in the Budget speech but included in the Budget document, outlined further details for the Business Bank announced by Vince Cable last year. A strategy document published today (21 Mar) will set out how the bank will develop between now and 2014 to provide long-term help for small businesses through £1 billion of funding. The bank will also provide immediate support through a £300 million investment scheme to help diversify and expand the supply of lending to businesses through non-bank lending schemes as mentioned above and will provide £75 million to expand the Business Angel Co-investment fund and extend the Enterprise Capital Funds.

Getting the financial system working efficiently again is essential for kick-starting the economy. Unless action is taken to fix the system and plug the gaps around business lending, there is a danger that the financial system will suffocate the aspiration nation before it has even taken its first breath.

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

Hiba Sameen *is a researcher at the Big Innovation Centre, an initiative of The Work Foundation and Lancaster University.*