Infrastructure Finance & Covid-19

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The UK government recently announced more than £600 billion of infrastructure spending over the next five years. The proposed spending signalled a change of direction following the austerity measures taken in the years after the Global Financial Crisis. This spending, however, may now be under threat as government finances are hit by the covid-19 crisis.

Borrowing for new infrastructure investment will be in addition to the borrowing needed to support the economy in the short term. Given the pressure on public finances, the government may need to reconsider its infrastructure priorities and its approach to borrowing and financing of infrastructure after the crisis. The response to the covid-19 crisis has seen unprecedented state invention in the economy which may change the relationship between the government and the economy in the longer term.

This post considers the policy options for further government borrowing and financing, and whether any longer-term changes in demand trends resulting from the covid-19 crisis could shape future infrastructure investment.

Scope for more government borrowing

The Office for Budget Responsibility (OBR) has warned that there could be a 35% fall in UK GDP in the second quarter of 2020 if the lockdown extends for three months. This would translate into an annual contraction of the economy of around 6 or 7%. The fall in tax revenue, an increase in the demand for social benefits, and the unprecedented measures taken by the UK government to support businesses means that the UK is heading for a significant budget deficit. The situation is evolving on a day to day basis and there is no blueprint from previous experiences as to how things may pan out. Public debt is now likely to be above 100% of GDP for the foreseeable future and could go much higher.

A high level of government debt is not incompatible with economic growth. The post war economic expansion was achieved with a debt to GDP ratio at higher levels than now. The current cost of borrowing is also very low in historic terms, which makes it easier to service the national debt. Prior to the covid-19 crisis the International Monetary Fund (IMF) recognised that the UK government had sufficient "fiscal space" to increase public debt to meet its investment objectives.

The UK government borrows by issuing gilts. The Bank of England has played an increasingly important role in the purchase of gilts in the secondary market in recent years, which has helped to reduce the cost of borrowing for government. The Bank has pledged to purchase a further £200 billion of gilts in the secondary market, which will take its holding of UK public debt to over 30%.

We are living through a period of radical policy change and government intervention

In the face of falling tax revenues and increasing spending demands due to the immediate covid-19 crisis, the UK government announced a quadrupling of its borrowing plans over the next three months. Since the crisis gilt yields have remained very low as investors have sought low risk safe havens as markets in general have become very turbulent. It is expected that the government will continue to raise debt for the foreseeable future by issuing gilts backed by an expansion of the Bank of England's quantitative easing programme.

If in the future there are liquidity problems in the gilts market then the Bank of England has agreed to directly finance the UK government. This financing is expected to be a temporary measure but in theory it could become more of a permanent feature. We are living through a period of radical policy change and government intervention. If the covid-19 crisis changes the political environment and the relationship between government and the economy on a more permanent basis, then direct monetary financing could be considered as a possible option for future government spending.

The implication of direct monetary financing by the Bank of England is that the government would no longer be dependent on the market to finance its spending. Money would be created by the Bank of England for public spending, and the only constraint on money creation would be the government's own inflation target. Interest rates have been stuck at close to zero for a number of years and with a deflationary risk associated with the covid-19 crisis the government could in theory finance large deficits with limited inflationary impact.

An expansionary fiscal policy financed by money creation could by-pass the established constraints of debt financing. Deficit financing is considered inflationary and the traditional policy response is to seek to lower the deficit. This approach resulted in the period of fiscal austerity after the Global Financial Crisis. Further austerity in the wake of the covid-19 crisis will be politically challenging.

Investing in infrastructure will increase the asset base of government. Assets that improve national productivity are likely to be prioritised, as higher productivity should be help balance the economic equation and eliminate the deficit through economic growth rather than through austerity.

Infrastructure during the covid-19 crisis

Core infrastructure is considered as a defensive investment during periods of economic uncertainty and market volatility, however the risk profiles and the returns provided by specific infrastructure assets across a wider definition of infrastructure, including non-core assets, can differ markedly.

Investor appetite for infrastructure assets has increased in recent years. Limited infrastructure investment opportunities due to the austerity constraints on government spending has widened the definition of what is considered an "infrastructure" asset, and infrastructure has become increasing blurred with other areas including real estate.

Some infrastructure assets will have to withstand significant cash flow stresses during the crisis, such as transport assets that are directly linked to the decline in economy activity. Renewables are also likely to be affected by the lower oil and gas prices. These impacts are only expected to be in the short-term, and liquidity made available by government should help support any temporary shortfalls. An extended lockdown and/or permanent changes to longer term business activity and revenue, however, could seriously impact asset values leading to an increasing number of distressed sales, rating downgrades, and defaults.

Infrastructure will remain critical but there may be some demand shift for certain services

The robustness of specific infrastructure investment debt structures and the strategies of infrastructure funds will be tested in this crisis. Specific assets with particular risk profiles will require different debt structures, reserves, and levels of debt service cover. Investments that are not structured to an equivalent investment grade level are likely to see an increase in the number of defaults and losses. Because of the lack of infrastructure investment opportunities in recent years, infrastructure asset values have become inflated and this is likely to mean that recovery values in the event of default may be lower than expected.

Infrastructure after the covid-19 crisis

Infrastructure will continue to remain critical to the economy. Many infrastructure businesses will be relatively unscathed as a result the covid-19 crisis and some could emerge stronger. For example, demand in certain areas such as digital services and healthcare is likely to increase. It is too early to assess whether there will be a major long-term demand shift because of the crisis, but some current trends could be exacerbated. For example, there may be less business travel and more on-line business activity, and in real estate investment there is likely to be a continued move away from traditional office and retail areas towards areas such as warehousing and data storage.

Some of the growth areas for private investment could have characteristics of both infrastructure and real estate. The "grey" area between real estate and infrastructure is likely to become wider as investors look to broader definitions of asset classes in order to get the returns they need. The levels of risk and return between alternative investment areas will need to be more transparent as more diverse investment portfolios are established. Investors in infrastructure and real estate assets have traditionally used different metrics to measure investment performance which makes it difficult to compare diverse portfolios.

It remains to be seen whether the government will have the fiscal flexibility to significantly increase core infrastructure spending after the crisis, and whether there will be an increased role for private financing of infrastructure. It will be difficult, however, to implement another round of austerity after the covid-19 crisis and the government has politically important infrastructure investment objectives. These include the levelling up of the regions of the UK through better road, rail, and digital communications and meeting its own climate change targets.

The recent Budget made some announcements about infrastructure investment, but details around the investment programme are due to be set out in the Spending Review later in the year. The National Infrastructure Strategy is expected to be announced ahead of the Spending Review. This will set out the UK's infrastructure priorities, the financing and delivery models, and the role of the private sector.

Infrastructure fundraising has been particular successful in recent years and there is a significant amount of private capital waiting to be invested in infrastructure. The lack of investment opportunities due to government spending pressures has pushed up valuations and has put fund managers under pressure to invest in riskier assets. The crisis is likely to create buying opportunities for funds with "dry powder" to invest and a government spending programme on infrastructure may also create a pipeline of investable assets that could be attractive to private investors.

Pressure on public finances may lead to a reconsideration of the role of private finance

Private financing of key core infrastructure has to some extent fallen out of favour with government in recent years, but if the government follows a more traditional approach to deficit financing then the pressure on the public finances may lead to a reconsideration of the role of private finance. A genuine transfer of risk which demonstrates value for money to the taxpayer, could take infrastructure assets and the associated debt off the government's balance sheet and help reduce the deficit. There would still be long term contractual obligations for the taxpayer to meet annual payments to private investors, but these would be smoothed out over a number of years during which time the economy would be expected to grow.

If the government considers using new policy tools such as directly monetary financing through money created by the Bank of England, then there may be less scope for the private financing of traditional core infrastructure. Private finance, however, would still be able to invest in the companies engaged in building and operating infrastructure assets on behalf of government, but private investors would not own infrastructure assets. Investors seeking asset backed infrastructure investments may need to consider more diverse non-core assets, including assets where there is more technological risk and market risk.

The covid-19 crisis has resulted in a raft of new policy initiatives by government some of which may be short-lived, but others may result in more permanent changes that could have important consequences for the financing of infrastructure. The level of public debt is expected to increase significantly due to the short-term measures taken in response to the covid-19 crisis and the longer-term infrastructure investment objectives of the government.

Dealing with pressures on the public finances could mean re-establishing policies such as the private financing of infrastructure or considering new ways of engaging with the private sector. Depending on the severity of the economic impact of the covid-19 crisis there may be the political willingness to experiment with radically new policy tools such as direct monetary financing in order to meet infrastructure investment objectives.

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