RESPONDER
Linking SCP and Growth Debates

Chris Hewett, Finance Innovation Lab

Background paper on The Role of Household Savings and Debt in a Sustainable Economy

1st Multinational knowledge brokerage event on
Household Finance & Sustainable Economy (London, 24-25 May 2012)

RESPONDER - linking **RES**earch and **PO**licy making for managing the contradictions of sustai**N**able consumption an**D** **E**conomic g**R**owth

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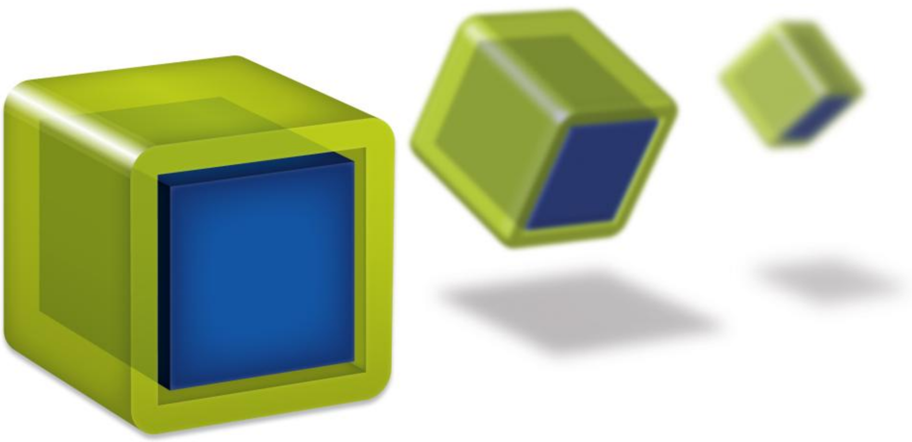

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1 Executive summary

This workshop on **The Role of Household Savings and Debts in a Sustainable Economy**, being held in London on 24/25 May 2012, is the first of two events designed to inform and create debate over how policy around household finance might need to change in order to facilitate the transition to a sustainable economy. It is part of the wider RESPONDER project to promote sustainable consumption by exploring novel ways of knowledge brokerage that help to improve the management of potential political, social and economic contradictions with economic growth. This paper is to provide the background and context for the workshop and accompanying research.

The role of debt in the current unsustainable economic model

In the last few decades, economic growth in the developed world was accelerated by a growth in private sector debt, funding increased consumption to generate income and jobs. Coupled with an economy still dependent on cheap fossil fuels for its energy, this has delivered a growth path that proved incapable of even starting a transition to a low carbon economy. This project will explore whether a different model, based on more savings to fund long term investment, could be better for sustainability and prosperity. There are three aspects of the system the project will examine:

- The relationship between debt and savings on the one hand, and spending on consumption versus investment in assets at a household level.
- The way in which household saving assets are deployed by the financial services sector as investment and debt across the economy, and how much change to the financial services sector is required to meet the investment needs of a transition to a sustainable economy.
- How would a financial system designed to deliver less debt, higher personal savings and longer term investment, impact on the ability of households to live in prosperity, and how would the way we manage our finances need to change?

Household finances: balance between consumption, debt & savings

There are already well documented differences between EU member states on attitudes to savings and the use of personal debt. The financial crisis of 2007/8 and subsequent Euro debt crisis are changing some of these attitudes. There is some evidence that the use of debt to fund consumption is declining, whilst borrowing to buy property is not. If the debt crisis has encouraged more people to save, what impact could this have on creating a sustainable economy? A great deal depends on how the funds are recycled into the economy by the finance sector.

How debt and investment need to be used for a sustainable economy

We know that the transition to a low carbon, resource efficient economy will need significant increases in long term investment in energy infrastructure, energy efficiency of buildings, clean technologies and public transport provision. We also know that a high proportion of debt created in the international banking sector is used to finance speculation and unproductive investment in assets such as property. Whereas other parts of the banking sector, such as the German savings banks or the members of the Global Alliance for Banking with Values, are focussing their lending on businesses which have greater social value. Stock markets, where many pension savings are invested, have a high proportion of fossil fuel and mineral extraction companies, as they tend to be large multinationals. The finance system could be steered towards more sustainable investment through a mix of encouraging banks and funds that explicitly promote social and environmental values, more control over the allocation of credit in the banking system and the use of public finance institutions, such as the European Investment Bank, to take on some of the financial risk of investment in new sectors.

Would this lead to greater prosperity?

For this economic approach to be politically feasible, the combination of encouraging a shift for European households to save more and borrow less, and a transformation of the financial system so it allocates more capital into more productive investment in sustainable activities, has to promise greater prosperity for the majority of people. The aim of the mapping work in the RESPONDER project is to create tools and analysis that make the answering of this question more possible.

2 The RESPONDER project

The overall aim of RESPONDER is to promote sustainable consumption by exploring novel ways of knowledge brokerage that help to improve the management of potential political, social and economic contradictions with economic growth.

The challenge is not just to bridge the gap between science and policy, but also to improve the mutual understanding between the “pro-growth community” (i.e. economists and policy makers oriented towards growth as an overarching policy goal) and the “beyond-growth community” (i.e. scientists oriented towards the limits to growth debate and policy makers involved in sustainable development). RESPONDER aims to improve the mutual understanding and knowledge transfer between these groups by using participatory systems mapping as a core methodology. So-called system maps serve as the basis for systematising empirical findings, questioning different model assumptions, analysing the effects of different policy options and identifying new research questions. Knowledge brokerage means that the project will not conduct new research in this area, but exploit existing research by new integrative modalities of linking research results to policy-making. In synthesis, RESPONDER:

- Links the sustainable consumption and growth debates: its overall aim is to promote sustainable consumption by exploring novel ways of knowledge brokerage;
- Links four communities: research, policy, pro-growth, and beyond growth;
- Aims to improve mutual understanding and knowledge transfer between these groups by using participatory systems mapping, in a series of Multinational Knowledge Brokerage Events on five sectoral policy areas – food, housing, household electronics, mobility and private savings/debts.

3 The role of debt in the current unsustainable economic model

3.1 The failed economic model of debt fuelled, consumption led growth

In the last few decades, economic growth in the developed world was accelerated by a growth in private sector debt, funding increased consumption to generate income and jobs. This trend has been more pronounced in US and UK, but to some extent all developed economies had followed this model. This reliance on consumption to deliver prosperity, coupled with an economy still dependent on cheap fossil fuels for its energy, has delivered an economic growth path that is incompatible with sustainable development and one which proved incapable of even starting a transition to a low carbon economy.

The financial crisis of 2007/8, which had its roots in the debt boom, saw a dramatic reduction in the credit available for individuals, businesses and governments. The consequent reduction in consumer spending, government expenditure and business investment is having a major impact on economic growth and employment. So the model has also now been shown inadequate to deliver on its own terms of delivering stable prosperity for all. The RESPONDER project is investigating other models of economic development that might be able to deliver prosperity and sustainability. This paper sets out some out some of the context for this work.

3.2 From debt fuelled consumption to savings based sustainable investment

If an economy based on debt to fund consumption is unsustainable, perhaps we need to explore one which is based on more savings to fund long term investment? In the US and UK, the years in the run up to 2007 were not only driven by consumer debt, but also very low savings rates amongst the population, compared to many other EU countries, such as France, Germany and Italy (Hewett, 2012). The caricature in the UK was a household sector borrowing to fund today's consumption, and the purchase of increasingly expensive property, at the expense of saving for the future and risking poverty in old age. In Spain, the property market has also been a major factor in the increase of personal debt. Would an economy more oriented towards savings, rather than debt, be better suited to sustainability? This is one of the key questions flowing from the work of Professor Tim Jackson in 'Prosperity without Growth' (Jackson, 2009).

3.3 Core questions of the RESPONDER finance workstream

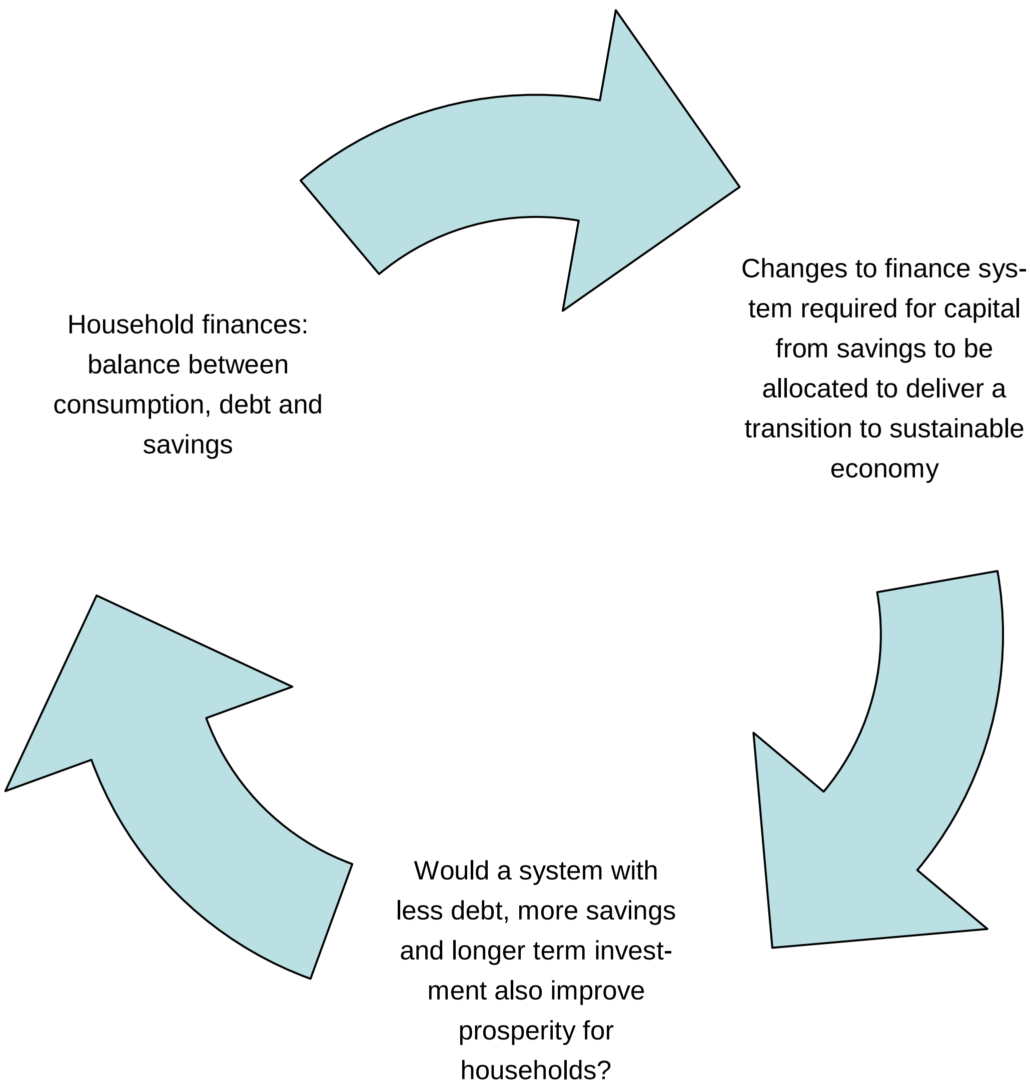
Part of the purpose of this project is to create a system map through which policymakers can explore different scenarios of economic development and the role of household finances in those scenarios. The mapping particularly needs to help policymakers think over different periods of time, short term and long term impacts. It may also enable links to other RESPONDER themes, given that savings and finance can be deployed as investments into energy, transport, food and ICT. This paper outlines the three aspects of the system that the project wishes to explore:

- The relationship between debt and savings on the one hand, and spending on consumption versus investment in assets at a household level.
- The way in which household saving assets are deployed by the financial services sector as investment and credit across the economy, and how much change to the financial services sector

is required to meet the investment needs of a transition to a low carbon, resource efficient economy.

- How would a financial system designed to deliver less debt, higher personal savings and longer term investment, impact on the ability of households to live in prosperity, and how would the way we manage our finances need to change?

These are very broad questions, and the first workshop will focus primarily on the first two of these, in the plenary sessions and the system mapping breakout sessions. Further papers expanding on the findings will be produced as 'knowledge units' from The Finance Innovation Lab later in 2012. A second workshop, to be held in early 2013, will focus in more detail on the second two of these fundamental questions.



4 Household finances: consumption, savings and debt

4.1 Consumer attitudes to debt and saving behaviour

To greater or lesser degree, all European countries are going through a debt crisis. Government austerity packages are reducing economic confidence and, in many cases, directly affecting household finances. Increased risk of unemployment, alongside reduced access to personal debt, is also leading to a radically changed context for household spending and consumption. Researchers are only just starting to understand the implications of these changes for households and the wider economy.

The workshop will look more deeply at the balance of household savings, consumption and debt, in order to consider how this might impact on a transition to a sustainable economy. First we need to look at how consumer debt has been used in recent times, looking at patterns of behaviour before the financial crash of 2007-8. How much of the debt expansion was actually financing today's consumption of goods and services, against the purchase of assets that last for many years, such as housing or cars. Alongside this, there is also important information about the proportion of income that is saved and the different use that households have for those savings such as retirement, short term financial security or one off purchases like Christmas presents or holidays. These patterns are different across the continent of Europe, and organisations like the Centre for European Policy Studies have analysed this data for many years, particularly the debt markets.

4.2 Attitudes to savings and debt across Europe

The most comprehensive study of saving patterns in Europe, compiled by BME Consulting and published in 2007 for the European Commission, looked in detail at the different ways that Europeans carried out long term savings (BME Consulting, 2007) The patterns present striking differences that have evolved over a long period of time and will have important implications for future saving an investment patterns across Europe:

- In France and Germany, around a third of long term savings are held in bank deposits, with less than half in pension funds or life insurance products, although the latter is growing.
- In Italy, bonds are more popular, accounting for a third of the savings market, with pensions only a quarter.
- Countries such as UK, Sweden and The Netherlands, pensions and life insurance are by far the dominant method of saving for the long term, accounting for three quarters of the market.
- In the UK and Sweden, only a very small percentage of long term savings (1-3%) are held in bank deposits.
- In Spain the direct ownership of mutual funds and quoted shares accounts for nearly half of long term savings, where as in many other countries this form of saving is being replaced by pension funds.

4.3 How has the financial crisis changed consumer behaviour?

Whilst most of the detailed data analyses are from before the 2008 financial crash, the interesting research questions are what impact the credit crunch and Euro debt crisis are having on these patterns.

The CEPR recently publish a briefing looking at deleveraging of European households and found differences in response. Denmark, the UK and Ireland all show a decline in household debt relative to GDP, since the peak in 2007. However, countries including The Netherlands, Spain, Portugal and Sweden have made little reduction; although it should be pointed out that their levels of debt were not as high as the UK or Denmark, even at their peak. (Fiorante, 2012)

Another interesting finding of this research was the divergent impact on debt for consumption, which has shrunk across Europe since 2008, against lending for house purchase, which stopped growing immediately after the credit crunch, but has since increased again. This diverging of the use of debt is a departure from pre-crash data where debt growth for consumption and house purchased rose and fell in step with each other. Does this mark a different attitude to the use of debt amongst European people? It is questions such as these that the RESPONDER project is seeking to illuminate, by developing a system map that examines how different debt and saving behaviours impact onto each other and ultimately the wider economy. By doing so we hope to learn about how resilience in household finances might be an important factor in creating a sustainable economy or, conversely, if our current patterns of household finance make the shift to sustainability even more difficult.

At a household level, financial behaviour is changing and research into on the ground changes in attitude is an important part of the evidence jigsaw. Recent work at the Personal Finance Research Centre at the University of Bristol will be showcased at the workshop. The researchers interviewed a sample of low and middle income families during 2011 to see how the recession and credit crunch had altered the way they manage their money. From a sustainable consumption perspective, one interesting finding was that cutting back on energy use and driving, was often part of their money saving strategies. In terms of attitude to debt, those in the middle were more likely to save up for purchases that they previously would have made on credit cards. At the lower end of the income scale, more families were becoming dependent on short term debt to make ends meet. (Finney, 2011)

4.4 Financial inclusion and debt dependency

Concerns over access to affordable debt for low income groups are a well researched field, but not often linked to sustainable consumption directly. Another report from PFRC, this time commissioned by the UK consumer protection group, Consumer Focus, showed the variety of ways this issue is handled in France, Germany and the UK (Consumer Focus, 2011). There is a rise in high interest, short term lending, in the UK – so-called ‘payday lending’, partly as a consequence of unemployment and inflation, but also a lack of access to other financial services such as mainstream banking.

Here there is a tension between the social damage caused by restricting access to affordable debt for low income groups, against the need to control the sort of sub-prime lending that helped trigger the 2007 crash. Solutions range from greater transparency in banking, to promoting credit unions and other community finance facilities for this segment of the population.

5 How debt and investment need to be used for a sustainable economy

5.1 How are household saving assets deployed as investment and lending?

Once households have accumulated savings they are usually deployed, via the financial markets, back into the economy. Some provide the capital stock for lending to businesses or other individuals to buy property. Pension assets are used to provide equity capital for business, but also lending to governments and corporations through the bond market. Given the different architecture of domestic financial services industries across Europe, and the variety of saving products used, there may be variations in the way these capital stocks are deployed in different EU economies. The question for RESPONDER research is what effects this might have on the prospects for a sustainable economy.

In addition, the role of the financial sector as intermediaries for this flow of money is vital to understand. What proportion of household savings is used to create profits and income directly from financial transactions in capital, currency and commodity markets and what impact does this have on productive investment?

5.2 Where does bank lending go?

The global nature of the finance sector in the City of London has been criticised by some as a factor in the UK's slow recovery from recession. Analysis from McKinsey Global Institute shows that the debt of the financial sector in the UK is far higher than the rest of the EU (Roxborough et al, 2012) and figures from the Bank of England show that a large proportion of that credit has been lent to other financial institutions and in the form of secured loans to individuals for property purchase. Less than 20% of the total UK bank lending goes to productive investment like infrastructure or business growth (TUC, 2012). This can be contrasted with other EU banking sectors, such as the German one, where local savings banks have a high market share of both personal savings (40%) and business loans (25%) (German Savings Banks Association, 2010). During the height of the credit crunch in 2007-9, German local savings banks continued to increase their lending to small and medium size businesses in the domestic economy, whilst the international banks of Frankfurt and London dramatically cut finance to such businesses, forcing some to close (Clarke, 2010).

So the way that deposits are deployed by the banking sector has a major impact on the wider economy. There is, of course a small part of the banking sector that is explicitly geared towards providing finance for businesses with a wider social and environmental purpose. The Global Alliance for Banking with Values (GABV) represents banks all over the world which carry out the business of taking deposits and lending to businesses in a very different way to the mainstream sector. Yet, it has recently published analysis to show that these banks have been as profitable as the mainstream, but far more prudent in their practices, and certainly required no bailouts from European governments during the financial crisis (GABV, 2012)

This story is further complicated by the fact that the pure intermediary function of the banking sector is not borne out by the way they actually operate in the market. Professor Richard Werner, Professor Steve Keen and other academics make the point that private banks have the power to create credit whenever they want. (Werner et al, 2011) A recent book from the New Economics Foundation, Where

Does Money Come From? , shows in some detail how the monetary system works in practice, as opposed to the theory of economic text books (NEF, 2011)

5.3 Are pension funds being invested sustainably?

Whilst savings in deposits are distributed by banks, other long term savings, such as pensions, life insurance and mutual funds, are primarily invested in the equity markets. The investments are made by financial intermediaries, who have a legal fiduciary duty to maximise the returns of the asset owner. Tracing where this investment is actually placed is notoriously difficult, but there is increasing evidence that the fiduciary duty has become misinterpreted by the long chain of financial intermediaries as meaning the maximisation of profits from share trading over the short term. The performance of fund managers is assessed by the pension funds that hire them typically over a three month period. If the value of their fund has fallen compared to competitors over that period, then they are very likely to be replaced. A civil society group in the UK, Fair Pensions, has carried out extensive research and dialogue with the industry and academics over this issue, and recommends a legal clarification of fiduciary duty to take into account the long term interests of the pension holder (Berry, 2011).

Because most equity funds only use stock exchange listed securities, the types of businesses that are listed on the European stock exchanges are the ones where household savings will be invested. One innovative piece of research has sought to trace the finance of the fossil fuel industry across the stock exchanges of the world (Carbon Tracker Initiative, 2012). It found The London Stock Exchange has become a very global market with an increasing number of its listed companies being based overseas, many in commodities and mineral extraction. By analysing the declared fossil fuel reserves of these companies, Carbon Tracker calculated that 18% of the world's total potential carbon emissions are owned by companies listed in London. This dwarfs the amount of the entire UK economy.

In other EU countries the structure of the stock markets are different, so the proportions of household savings going to unsustainable activities may well be smaller. The financial sectors are also not so dominant outside the UK, so there are different flows of household savings into business lending, share capital and even the purchase of property. A comparison across EU economies and the role of household finances within, them could be potentially illuminating for the options of how to develop a sustainable economy at a national level.

5.4 What are the investment needs for a transition to a sustainable economy?

If Europe is to deliver a transition to a sustainable economy that is low carbon and resource efficient, we know some very large investments will need to be made across Europe in key sectors. The European think tank E3G has estimated that a shift of at least 1.5 -2.1 trillion Euros into low carbon sectors will be required to deliver a 30% reduction in greenhouse gas emissions be 2020 (Holmes et al, 2012). They estimate that up to 700 billion Euros may have to come from public sector financing, but the rest would have to be private capital. This investment would be in new energy infrastructure, energy efficiency in buildings, public transport and clean vehicle technology.

Some studies argue that such a low carbon investment path would actually provide economic benefits for Europe, including higher economic growth than there would otherwise have been, and more employment (Jaeger et al, 2011; Zenghelis, 2011) This level of investment in low carbon energy will only happen with significant certainty about the direction of emissions policy in Europe. E3G also argue that public finance institutions, such as the European Investment Bank will also have to play a major role. The 'degrowth' analysis obviously goes further than this to say that the nature and pace of all economic activity will have to change in order to reach the more challenging carbon targets of 2030 and 2050 (Jackson, 2009).

5.5 Prioritise investment that reduces future consumption

One way to square this circle, and potentially link to other elements of the RESPONDER project, will be an understanding of what investments could be made today, that would reduce future demands on consumption. Energy efficiency is the clearest example of this, but fuel efficient vehicles and public transport could be others. For example, if more pension fund assets were invested in improving the energy efficiency of the building and vehicle stock, then the fuel needs of future generations would be reduced, allowing more of their income to be used on other aspects of household consumption, or to build up savings. This is particularly important for the elderly who spend more time in their homes, so frequently have higher demand for heating, for example.

5.6 How will the finance sector need to change in a sustainable economy?

If the financial services industry in the pre crisis era has proved incapable of delivering the investment for a sustainable economy, how might it need to change in order to steer private capital into the right places? There are many suggestions out there, and no one solution that will solve all of the existing barriers to a sustainable economy. Broadly they fall into three categories:

- Grow the socially responsible lending institutions including community and local banks, credit unions, members of GABV, peer-to-peer lending as well as socially responsible investment at equity and fund levels.
- Governments taking more direct control over the allocation of credit, either to curb speculation, or encourage more lending to the productive economy or even sustainable investment. This could be done through credit guidance, administered by central banks, and/or through the direct intervention in the markets from public finance institutions such as the European Investment bank.
- More proactive government policy encouraging institutional investment into low carbon, resource efficient future, including public finance institutions taking on long term policy risk, creation of a green bond market or setting a 'long, loud and legal' policy framework for emissions policy that makes returns on sustainable investments more certain.

6 How would a new economic model affect prosperity?

For this economic approach to be politically feasible, the combination of encouraging a shift for European households to save more and borrow less, and a transformation of the financial system so it allocates more capital into more productive investment in sustainable activities, has to promise greater prosperity for the majority of people. The aim of the mapping work in the RESPONDER project is to create new knowledge and insights that could be used by policymakers, economic modellers, investment professionals and academics. The sort of questions we hope that could be informed by the mapping include:

- What would be the economic impact of more household savings and less consumer debt? Lower consumption of goods and services in the short run, but an increase in investment in business capacity and infrastructure over the medium term?
- If a higher proportion of the savings were deployed in resource efficient investments in the national economy, how would future consumption be affected?
- Can mechanisms to efficiently utilise more household saving assets to sustainable investments be created?
- What forms of financial intermediation are best suited to deploying individual savings in a way that accelerates investment in sustainable technologies and approaches?
- What role does the financial services sector play in the efficient deployment of savings to investment, and how can the needs of future generations be effectively taken into account?
- What policy instruments can be used to reduce debt dependency for low income groups, whilst still offering them prospects of greater prosperity?
- Can the financial system give greater access for middle income groups to higher returns on their savings capital whilst simultaneously allocating more to sustainable investments?

7 Outline of the workshop

The workshop being held in London on 24/25 May 2012 is the first of two events designed to inform the research process and create knowledge brokerage around the topic of how policy around household savings and debts might need to change in order to facilitate the transition to a sustainable economy.

The opening session will be a keynote speech from **Professor Tim Jackson, of University of Surrey**, and author of Prosperity Without Growth. He will outline the intellectual context for the event, setting out why we need to know the answers to these questions in order to develop a new economic approach that could deliver sustainability. He will be joined by two respondents: **Dimitri Zenghelis, Visiting Fellow of the Grantham Research Institute on Climate Change and the Environment**, at the London School of Economics, and **Greg Ford from Finance Watch**, a Brussels based independent public interest association dedicated to making finance work for the good of society. After a break, there will be three table discussion groups on different new developments in the finance sector seeking to connect individual savings to social or environmental investment. These will be led by **Karl Richter, of the Euclid Network**, and an international expert in social investment**, Bruce Davis founder of Abundance Energy**, and a leading player in the rapidly growing peer to peer finance industry who will speak about democratising finance, and **Chris Hewett, Fellow of the Finance Innovation Lab**, on research into ways tax policy can be used to promote more sustainable investment.

After lunch on day 1, there will be a session looking at the patterns of debt and savings behaviour in the UK and how the financial crisis may be changing these, placed in the context of the variety of different personal savings and debt behviours observed across the whole of the EU. **Andrea Finney from the Personal Finance Research Centre at the University of Bristol**, will be the key speaker here.

The first system mapping breakout sessions will be introduced by **Andre Martinuzzi, Associate Professor at Vienna University of Economics and Business**, and lead co-ordinator of the RESPONDER project. There will be three groups each led by a facilitator with expertise in system mapping methodoogy. Each group will explore one of the following three questions:

1. **Should we favour sustainable investment over unsustainable consumption in a downturn?**

   During periods of recession and low economic growth there is often a concern that expectations of future low incomes lead to higher savings rate and declining spending on consumption, further reducing economic growth and job creation. Say that instead of promoting increased consumption, at this point in the economic cycle, an increase of investment in energy efficiency would be pursued. What would be the implications for prosperity?

2. **What are the implications of choices in allocation of credit in an upturn?**

   As incomes rise in an upturn, the anticipation of future income increases and asset value uplift often leads to a rapid extension in credit in the economy. This credit is allocated to productive investment (expanding income generating businesses) and unproductive investment (financial speculation and purchase of property assets). What would be the implications for prosperity of controlling the way that this credit is allocated?

3. **How do we prevent low income groups becoming dependent on debt?**

   To what extent do middle and lower income households become overdependent on debt, in economic upturns and downturns, in order to fund levels of consumption to maintain social standing? As borrowing increases, the proportion of income that has to go towards servicing the debt also increases, exacerbating the problem and creating a downward spiral. What are the implications for the choices those groups have to make on how they spend their money, in terms of their ability to build economic security for themselves and invest in ways that improves their quality of life?

Following these groups there will be a drinks reception and a keynote speech from **James Vaccaro, of the Global Association for Banking with Values** (GABV). James will describe how their member banks all over the world are reconnecting savers with sustainable investment.

There will be a buffet dinner for all delegates after this speech at 6.30pm.

On day 2, following feedback from the facilitators on the system mapping sessions, there will be a second round of breakout groups, where delegates review the work of other groups and build on the system created. The final plenary session will consist of two keynote speakers and a discussion. **Professor Richard Werner, Director of the Centre for Banking, Finance and Sustainable Development at the University of Southampton**, will decribe how credit is currently allocated in the banking system across Europe and how this impacts on sustainability. He will be joined by **Kent Hudson**, a leading expert in the USA Community Re-investment Act, and advocate of how its principles could be applied to the European finance sector.

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