Invest 2035: The UK's Modern Industrial Strategy

November 2024

Positive Money welcomes the opportunity to respond to the UK Government's consultation on the Industrial Strategy green paper.

Positive Money is a not-for-profit research and campaigning organisation, working towards reform of the money and banking system to support a fair, democratic and sustainable economy. We are funded by trusts, foundations and small donations.

1. How should the UK government identify the most important sub sectors for delivering our objectives?

If a sectoral approach is taken, sub-sectors should be identified according to the needs of net zero and environmental objectives, and interlinked objectives of economic security and resilience. Selecting sub-sectors based on assessed strength of output growth, productivity, and international position, as proposed in *Invest 2035*, risks undermining the aforementioned objectives of the strategy that are essential prerequisites to a strong economy.

Climate change and nature loss pose severe threats to economic output and stability that in themselves are prerequisites for economic growth. These impacts are already being seen and will increase in severity as climate change and nature loss intensify. Available evidence points to climate change severely reducing economic output. The Network for Greening the Financial System estimates that under current policies, which imply a global temperature rise of 3 degrees, global GDP could be reduced by up to 15% by 2050,[1] whilst the LSE Grantham Institute suggests a reduction of 3.3% to UK GDP.[2] The Green Finance Institute further estimates that nature loss could result in a 12% loss to UK GDP by the 2030s.[3] Though significant, these figures omit key variables including tipping-point dynamics, as well as compounding risks and socioeconomic impacts such as migration or conflict, meaning they are likely underestimates. As well as GDP losses, increasing frequency of extreme weather events driven by climate change and nature loss, alongside energy price shocks derived from ongoing fossil fuel reliance, increase the risk of supply-side shocks creating inflationary pressures. For instance, ECB researchers recently estimated that climate change could increase headline inflation by 3.23 percentage points by 2035 via impacts on food prices alone.[4] This interrelationship

[1] NGFS (2024). NGFS Climate Scenarios for central banks and supervisors - phase v.https://www.ngfs.net/en/publications-and-statistics/publications/ngfs-climate-scenarios-central-banks-and-supervisors-phase-v

[2] Rising et al. (2022). Policy brief: What will climate change cost the UK? *LSE Grantham Research Institute on Climate and the Environment.* https://www.lse.ac.uk/granthaminstitute/wp-content/uploads/2022/05/Climate-costs-UK-policy-brief.pdf

[3] Green Finance Institute (2024). Assessing the Materiality of Nature-Related Financial Risks for the UK. https://www.greenfinanceinstitute.com/wp-content/uploads/2024/06/GFI-GREENING-FINANCE-FOR-NATURE-FINAL-FULL-REPORT-RDS4.pdf

[4] Kotz et al. (2024). The economic commitment of climate change. *Nature*. https://www.nature.com/articles/s41586-024-07219-0

between climate, nature, clean energy and economic growth and stability mean that sub-sectors must wholly support these objectives in order to achieve the government's industrial strategy aims.

4. What are the most important subsectors and technologies that the UK government should focus on and why?

We recommend that the Government reconsider the selection of the financial services sector as a priority growth sector for the industrial strategy. If included, a Sector Plan for financial services should prioritise 'market shaping' objectives rather than pursuing overall growth of the financial sector.

There is a wealth of empirical evidence illustrating that above a certain threshold, there is a negative relationship between financial sector growth and the growth of the wider economy.[5]

Conflict between the growth of the financial sector and the real economy occur through various channels, including:

- a disproportionately large financial sector misallocates credit towards assets that can be used as collateral and non-productive activities, driving asset price inflation and large debt burdens which drag on the real economy;
- increased lending for financial intermediation drives higher levels of private debt and excessive extraction of economic rent from households and non-financial firms;
- a 'brain drain' effect whereby people and resources are drawn from other economic sectors, particularly the research and development intensive industries the government is also trying to grow;
- increased occurrence of financial crises when risks crystallise, the costs of which are then borne by the government and lead to deeper and longer recessions than may otherwise occur;
- large net foreign inflows into UK finance can raise the real exchange rate, reducing the competitiveness of other sectors internationally. Given this, we are concerned that an overall focus on growing the sector will hinder achievement of broader aims.

In recent decades, the UK banking sector's support for productive investment has also declined significantly as a proportion of the sector's overall size, with lending increasingly favouring lending to other financial institutions and for purchasing property. Positive Money's analysis of Bank of England data finds that as of July 2024, the stock of loans held by non-financial corporations stands at just 16.7% of total lending, or £435 billion –

[5] Cecchetti, G and Kharroubi, E. (2021). BIS Working Paper No. 381: Reassessing the Impact of Finance on Growth.https://www.bis.org/publ/work381.pdf ; Baker et al. (2018). The UK's finance curse? Costs and processes. *Sheffield Political Economy Research Institute (SPERI), University of Sheffield.* https://eprints.whiterose.ac.uk/143275/1/Baker%20The-UKs-Finance-Curse-Costs-and-Processes%20final.pdf

about half of outstanding credit compared to 2010 in inflation-adjusted terms. Outstanding mortgage lending now makes up 53.8% of all lending by commercial banks, and 24% of total lending goes to financial corporations.

That the share of total lending going to mortgages has increased from 39% in the beginning of 2009 to 53.8% by July 2024 while lending to the real economy has fallen, implies that the growth model of the financial sector has not changed since the financial crisis but continues to rely on asset-price inflation rather than growth in the real economy. This continues to negatively impact the growth prospects of the real economy, as can be seen by the fact that the annual net change in lending to the productive sectors of the economy (industries that are not in the financial, insurance or real estate, or 'FIRE' sector) decreased by £5 billion in 2021, by £5.6 billion in 2022, and by £8.5 billion in 2023. On a sectoral basis, manufacturing, construction, transport and retail have all seen negative annual changes in net lending in recent years.

Academic research has identified this shift away from real economy lending to be due to a number of factors, including:

- Demutualisation and deregulation of the banking sector in the 1980s, which drove consolidation and a shift in bank activity away from primary lending and deposit taking activities;
- The decline of credit guidance policies.[6]

Credit market liberalisation driven by these factors supported the growth of broader non-productive financial activities, as outlined above, with aggregate impacts on economic growth. This is supported by empirical academic evidence based on UK data that has found a positive relationship between growth of bank lending to the real economy and nominal GDP.[7]

A Sectoral Plan for financial services should therefore prioritise 'market shaping' objectives beyond overall sector growth, such as:

- Increasing the diversity of the UK banking sector, particularly stakeholder banks (e.g. cooperative banks, mutuals and building societies and credit unions);
- Increasing the proportion of sector's financing going to other priority sectors of the industrial strategy and the wider real economy (such as via reintroduction of forms of credit guidance);
- Reducing financial flows going to activities with outcomes that run counter to key objectives of the strategy, such as financing of fossil fuel expansion.

5. What are the UK's strengths and capabilities in these subsectors?

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[6] Bezemer et al. (2023) Credit policy and the 'debt shift' in advanced economies. *Socio-Economic Review.* https://academic.oup.com/ser/article/21/1/437/6413687

[7] Ryan-Collins et al. (2016). A half-century diversion of monetary policy? An empirical horse-race to identify the UK variable most likely to deliver the desired nominal GDP growth rate. *Journal of International Financial Markets, Institutions and Money*. https://www.sciencedirect.com/science/article/pii/S1042443116300208

Within the financial services sector, green finance presents an opportunity for the UK to build on its existing leadership role. The UK was an early mover in developing policy and regulatory frameworks for green finance markets, however, to truly be a leading green finance centre, the aim ought to be to fully align financial sector flows with Net Zero and nature goals. This includes swift implementation of delayed commitments made in key elements of the 2023 Green Finance Strategy such as the UK Green Taxonomy and Labour's manifesto commitment to require publication of 1.5 degree aligned transition plans from all financial institutions and FTSE-100 companies. As well as these regulatory tools, utilising a broader suite of measures to shift the incentives for the financial sector is ultimately needed in order to align the sector with Net Zero, including adapting macroprudential and monetary policy tools to send clear signals to the market (in line with an overall 'market shaping' approach to financial services policy, as proposed in response to question 4).

7. What are the most significant barriers to investment? Do they vary across the growth-driving sectors? What evidence can you share to illustrate this?

Increasing cost of capital as a result of higher interest rates poses a significant barrier to investment for Clean Energy industrial sectors, which are highly capital intensive and often incur almost all costs upfront, with clean energy firms typically more highly geared than fossil fuel incumbents.[8] This contrasts strongly with the oil and gas sector, which is less sensitive to rate rises due to being comparatively cash rich and less reliant on debt financing. Despite this, these companies are failing to transition their business models, with a recent study from Oxford Sustainable Finance Group finding that in 2022/23, despite the total value of capex by public oil and gas firms being almost matched by the value of share buybacks and cash dividends, low-carbon investments by oil and gas firms were equal to just 1.9% of total oil and gas upstream capex in 2023, and equal to just 0.9% of global low-carbon investment. Uplift analysis affirms this for the UK context, finding that 74% of offshore oil and gas companies in the UK plan to invest solely in oil and gas production between now and 2030.

One mechanism to reduce this disadvantage is repurposing the Bank of England's existing Term Funding Scheme (TFS) to pass through lower interest rates to clean energy companies. The TFS offers cheap funding to commercial banks, provided that they demonstrate they have expanded lending to households and businesses. The most recent iteration also offered additional incentives for SMEs (TFSME). This scheme could be adapted to offer below Bank Rate funding to clean energy sectors, supporting investment as well as meeting the Bank of England's mandate for price and financial stability by reducing risk of fossil-fuel price shocks and reducing future economic and financial risks induced by climate impacts.

[8] Wood Mackenzie (2024). Conflicts of interest: the cost of investing in the energy transition in a high-interest rate era. https://www.woodmac.com/horizons/energy-transition-investing-in-a-high-interest-rate-era/

15. How can investment into infrastructure support the Industrial Strategy? What can the UK government do to better support this and facilitate co-investment? How does this differ across infrastructure classes?

Multiple sectors benefit from underpinning infrastructure, and investment will be critical to industrial strategy success. Despite the benefits received, the incentives and capacity for the private sector to coordinate, finance and build critical infrastructure where it is required is low. This means that public investment, particularly via policy banks such as the new National Wealth Fund, is necessary. The National Wealth Fund could act as a key coordinating body for UK infrastructure investment, mobilising private capital whilst ensuring a fair deal for the public sector and seeking to actively shape markets whilst doing so to achieve the wider aims of the industrial strategy.

In line with the National Wealth Fund Taskforce's recommendations, we think that the best way to mobilise private capital is to give the fund the capacity to leverage its own balance sheet and mobilise capital at the fund level. This could allow the fund to more effectively channel institutional capital to where it is needed at greater scale and pace than is likely on a deal-by-deal basis, and would have the benefit of allowing the fund to use returns from higher-revenue projects to invest in essential infrastructure that provide critical, collective benefits, yet may be harder to monetise, and if pursued on a deal-by-deal basis would require significant Government subsidy.

20. Do you have suggestions on where regulation can be reformed or introduced to encourage growth and innovation, including addressing any barriers you identified in Question 7?

The industrial strategy green paper notes that one of the strategies' net zero objectives will be to align sector plans with Net Zero and environmental objectives, and to identify and support Clean Energy industrial sectors with the greatest growth potential. However, the UK financial sector is not aligned with net zero and environmental objectives nor sufficiently driving green innovation, both of which could be supported through a more effective regime of financial regulation.

In relation to climate and the environmental risks and the need to finance the green transition, the UK has to date relied heavily upon disclosure initiatives that aim to increase the information on environmental risks available to market actors to encourage the internalisation of environmental risks into market pricing (e.g. TCFD and TNFD). Such an approach is insufficient when it comes to environmental-related financial risks, due to the inability of climate and nature-related financial risk models to capture complex, non-linear dynamics including ecosystem tipping points, socio-economic impacts (like conflict and migration) or compounding risks, which results in downside risks being underestimated. Likewise, the benefits of green innovation are also poorly captured.

As a result, existing regimes have also proven ineffective in practice after several years of implementation, with the UK financial sector continuing to finance activities that are not in line with net zero and environmental goals. Most prominently this includes fossil fuel expansion, which the International Energy Agency has stated must be halted in order to reach net zero. The five largest UK banks' provided almost £39 billion in financing for fossil fuels, an increase from the total amount financed in 2022, with approximately a third of this going to oil, gas and coal companies who are actively expanding fossil fuel production.[9]

Academic research has demonstrated that the financial sector is not just a passive enabler, but actively shapes an economy's trajectory, meaning that real-economy regulation cannot be relied upon on its own to green the financial system. This approach would also fail to address the global impact of the UK financial sector on climate and environmental degradation, undermining the UK's role in global commitments. Effective green financial regulation will also mean that the financial sector is more resilient to changing real economy regulation. Options include: the adjustment of capital requirements on environmentally harmful lending such as fossil fuel expansion; greening of central banks collateral frameworks (which have a strong signalling effect, impacting financial market pricing, and currently favour damaging lending); the introduction 1.5 degree-aligned transition plans for financial institutions, and public green and dirty taxonomies.

23. The UK government currently seeks to support growth through a range of financial instruments including grants, loans, guarantees and equity. Are there additional instruments of which you have experience in other jurisdictions, which could encourage strategic investment?

As highlighted in response to question 15, the National Wealth Fund could act as a key coordinating body for UK infrastructure investment, mobilising private capital whilst ensuring a fair deal for the public sector and seeking to actively shape markets whilst doing so to achieve the wider aims of the industrial strategy.

In line with the National Wealth Fund Taskforce's recommendations, we think that the best way to mobilise private capital is to give the fund the capacity to leverage its own balance sheet and mobilise capital at the fund level. This could allow the fund to more effectively channel institutional capital to where it is needed at greater scale and pace than is likely on a deal-by-deal basis, and would have the benefit of allowing the fund use returns from higher-revenue projects to invest in essential infrastructure that provide critical, collective benefits, yet may be harder to monetise, and if pursued on a deal-by-deal basis would require significant Government subsidy.

[9] Rainforest Action Network (2024). Banking on Climate Chaos. https://www.bankingonclimatechaos.org/

28. How should the Industrial Strategy accelerate growth in city regions and clusters of growth sectors across the UK through Local Growth Plans and other policy mechanisms?

The National Wealth Fund will be a critical lever for delivering the industrial strategy, and ensuring that investment supports Local Growth Plans. It is welcome to see that the government plans to give the fund a strong regional objective, and that the fund will work in close partnership with Mayors. However, the NWF's governing board (inherited from the UK Infrastructure Bank) lacks representation from regional authorities or trade unions representing key industries in these areas. Alongside issuing the NWF with an updated mandate, statement of strategic priorities, and framework document, the government should take the opportunity to reform the NWF's governing board to reflect these new priorities, including regional growth. Germany's KfW, for instance, has the composition of its Supervisory Board specified in law, consisting of 37 members including four trade union representatives, two representatives of industry and one of representatives of each of the municipalities.

More widely, the UK's banking sector currently reinforces regional inequalities, which a sector plan should seek to address. Small and Medium Enterprises form the backbone of many UK regions and local areas, yet are underserved by the UK's banking sector, with the NAO judging in 2019 there to be an 'SME finance gap' of £22 billion. The UK's banking sector is unusually concentrated, and dominated by a small number of large, shareholder-owned banks for which SME lending is unattractive, largely due to requiring relatively small loans with high transaction costs. A Sector Plan for the financial sector should therefore prioritise addressing this, namely by supporting the growth of stakeholder banking models that are better placed to lend to local economies, including community development finance institutions (CDFIs), credit unions and mutuals.

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