

Supporting the green transition

Finance is one part of the solution to the transition to net zero and the protection of the environment, but it cannot be a substitute for government action. The priorities for accelerating the climate transition have been clearly identified during this session, but there are still a number of difficulties.

1. The priorities for accelerating the climate transition have been identified

1.1 Technology will be a gamechanger, but investments need to make economic sense

An industry speaker commented that banks are not the final investors in technology projects. Banks lend to investors, and investors only borrow money from banks if they see a financial return on their investment. Investors are not going to change their financial behaviours unless the green cost premium is reduced and an enabling policy framework is created.

Some investments make economic sense because the technology is already viable. The way to increase the number of these projects is to create a better system of permissions and to make it easier to do business. Other technologies are proven technically but not economically. For these projects, public resource is required to incentivise private investment. These projects include technologies with a green cost premium such as carbon capture, green steel and green cement, sustainable aviation fuel or hydrogen. There are also projects that are not yet proven technologically, such as nuclear fusion, electric planes or truly smart grids. These projects will require both public and private sector money and the help of other stakeholders, such as universities, companies and other civil organisations.

1.2 Transition finance must recognise geography while supporting common goals

An industry representative highlighted the global dimension to the green transition. If Organisation for Economic Cooperation and Development (OECD) emissions were zero, the world would miss its climate targets due to emissions growth in Asia and Africa. It is cheaper to borrow the money to build a solar plant in France than in South Africa, yet the emissions displaced by one in France are a fraction of what would be displaced in South Africa due to the higher carbon intensity of the electricity grid in the latter. Development risks, combined with the cost of capital and the low returns in some markets mean there is no pipeline of projects. Without a pipeline of projects, these projects simply are not built.

In other words, transition finance needs to be context specific. It should take account of the policy and socioeconomic realities of the transitions in different jurisdictions and industries. In practice, the activities and sectors considered to be 'supporting the transition' will vary geographically and over time. In emerging markets, the Just Energy Transition Partnership (JETP) frameworks can help bring together donor governments and create blended finance offers by enabling donors, host governments and commercial banks to determine where concessional finance can tackle blockages in the demand pipeline. An internationally aligned approach can only be facilitated if local requirements are consistent with global initiatives, such as the work of the International Sustainability Standards Board (ISSB). The regulators should focus on maintaining this consistency and ensuring that local frameworks have sufficient flexibility to accommodate evolving practice in developing credible transition plans.

1.3 Overcoming technological and regulatory uncertainty

An IFI representative explained that the key issue is money. There is a need for money at liquid and price effective conditions to finance projects deemed too risky for the private sector. Public money must leverage private resources. This will enable projects to be financed while bringing more money into the sector. Some projects are considered risky due to technological uncertainty: No one knows for instance what fuel will be used in plane whether it will be hydrogen, sustainable fuel or other technology. But there is also a problem with regulatory uncertainty. There is no visibility on the future of regulation. Investors want assurances that they will get a return on their investment.

There is also the question of global competition. A global problem requires a global solution. Europe is taking the lead on this issue, but there is a critical need for a wider adoption of mechanisms like the Emissions Trading System (ETS) or Carbon Border Adjustment Mechanism (CBAM). Other countries are already putting in place measures to make their products compliant with these initiatives.

1.4 Green growth requires both profound political commitment and proper regulation

An official agreed with the urgent need to address climate change. Last week, the G20 recognised the need to accelerate investment in renewables. Any future growth will need to be green to be sustainable. There is a business case to be made about the economic value add of green growth, which is connected to strategic autonomy. There will be an additional value add to reducing Europe's dependency on certain producers and on critical raw materials. Green growth will therefore provide a double dividend: there will be a greener and

more productive economic structure and industry will be more competitive. This is even more important in view of increased international competition.

There are three ways to address the challenges. First, leaders and ministers must continue to demonstrate political commitment to the process. Driving growth in a green environment will require public investment at national and EU level, private investment and regulatory reform. Secondly, businesses must be prepared for the regulatory shock. It will be essential to ensure SMEs can remain competitive while making these adaptations. Finally, there must be an international dimension to the transition. After the Eurofi conference, ministers from Europe, Latin America and the Caribbean will be meeting in Santiago to discuss the green transition and the joint green investment agenda.

1.5 Aligning EU capital markets policy to support the green transition

An industry speaker underlined that banks and other market participants have a core role to play in supporting the green transition. 70% of Europe's financing needs are provided by the banks; 30% are provided by the capital markets. This is the inverse of the US. From the perspective of investors, this 30% needs to increase significantly. The availability of green projects can be increased by creating packages of investments. Europe continues to evolve the European Long-Term Investment Fund (ELTIF) framework to channel private savings towards long term infrastructure investments. With some tweaks and perhaps greater competition from other wrappers or packages, there should be an increase in green investment. It would also support the green transition if member states' pension systems were reformed to allow a greater proportion of savings to be invested in the capital markets.

2. There are several difficulties preventing the implementation of these objectives

2.1 Economic and regulatory bottlenecks

An official outlined the economic and regulatory bottlenecks which have emerged from the political process of addressing climate change. Transition paths are determined by climate change experts, but there is no discussion of whether these paths are realistic. Electromobility is an example of a significant bottleneck. In some areas, the grid cannot support the installation of enough electric vehicle charging stations to serve the local population. This is not a problem of political will; it is a bottleneck that was not considered in the calculation of the transition path. For some countries, it is easy to produce 100% renewable energy. It is much more difficult to tell people who own gas boilers that they must replace them. The political difficulty of this process has become clear over the past year, but there will be significant consequences if these economic bottlenecks are disregarded.

2.2 Ending fossil fuel subsidies and supporting alternative energy mechanisms

An industry representative cautioned against using developed nation's indebtedness as a reason not to invest in reducing emissions. The counterfactual is not what exists today but what will happen tomorrow. It will not be possible to burden emerging markets, impose CBAM on their exports, not provide debt relief and then expect them to make emissions reductions unless we do so ourselves. There must be some give in the system. One option to create fiscal space would be the removal of fossil fuel subsidies. At the moment, governments support the exploitation of fossil fuels to a greater extent than they support mechanisms for alternative energy. There must be a global carbon price. Business models and consumer habits are often based on brown subsidies. Politically, the abolition of brown subsidies is not a free lunch.

The Chair suggested that carbon intensive agriculture subsidies could also be removed, including the Common Agricultural Policy (CAP).

An industry representative noted that, excluding flights, diet is the biggest contributor to a person's carbon footprint. Farmers in the EU are being subsidised to produce carbon-intensive products. If these subsidies were removed, there would be a transformation. If the green transformation is prevented, the European economy will be overtaken. For example, 50% of the vehicles produced in China are now electric vehicles. Chinese manufacturers will dominate the world market unless Europe's electric vehicle transition is accelerated.

An IFI representative agreed on the need to re evaluate the subsidies for fossil fuels and agriculture. Usually, the argument is made that people do not want this and that it would create a huge social problem. The argument that people do not want it is not correct. Surveys suggest that between 66% to 90% of people support more stringent measures and additional costs because they believe they will see long term benefits such as higher income, more jobs and a better quality of life. The question of social cost should be left to social policy. The money generated by removing subsidies should be spent on the people who are worse off. These decisions should be made based on the price system, which is how costs are revealed and internalised. It is also important to bear in mind that some overindebted countries are not contributing to climate change but are suffering the consequences of it. These countries should be enabled to transition without suffering excessive penalties through mechanisms such as debt for climate swaps or the reallocation of SDRs.

2.3 CBAM is a major breakthrough for global climate diplomacy, but it has its limits

A policy maker emphasised that 2050 is now a legal commitment. The market based mechanisms like ETS or CBAM work by providing incentives for industry. Instead of regulating the carbon content of products, which might happen in the next decade, the decision was made to create a market based mechanism that incentivises industries and investors to create greener products by providing a price signal. CBAM seeks to incentivise

companies in third countries to align with companies in Europe on decarbonisation. It is already having a triggering effect. Turkey is developing its own ETS, and Serbia, Japan, South Korea, China, Indonesia and New Zealand are all expanding or thinking about expanding their approach to carbon pricing.

The CBAM regulation with financial obligations will enter into force in 2026. There will be until then a transitional period during which there will be a period of intense cooperation on decarbonisation measures across the OECD, the Inclusive Forum on Carbon Mitigation Approaches (IFCMA), the Climate Club, the International Monetary Fund (IMF) and the World Trade Organization (WTO). There is a broad focus on the merits of carbon pricing as a complementary tool. The system for carbon pricing in Canada or China might not be identical to the one in the EU, but the world is moving towards more carbon pricing, and a higher carbon price is better for the environment.

An industry speaker noted that BBVA has advised its clients and the authorities in Turkey that Turkey should create its own ETS or else Turkish businesses will end up paying taxes in Europe.

A policy maker added that both the Nigerian President and the CEO of Tata Steel have recently identified the opportunity to green through carbon pricing.

A policy-maker agreed that CBAM is a very good idea. The entire system can only work with a border adjustment mechanism. However, there is a significant problem around product inputs from third countries. There is no problem if a product is 100% produced in Turkey, but the rules of origin are such that, if 49% of the product comes from outside Turkey and there is no adjustment mechanism between Turkey and the country of origin, this CO₂ will not form part of the CBAM calculation.

2.4 Decisive action is needed in the EU banking sector due to over reliance on bank financing

An industry speaker explained how citizens both in the EU and abroad can support the transition by using their own pension savings to invest in effective investment vehicles as part of a truly unified EU capital market. In particular, securitisation will free up bank balance sheets and allow banks to participate in more green financing. It is important to understand whether the current rules and regulations on securitisation, insolvency law and taxation are supportive of international investment in these projects. The world's largest global asset owners consider tax to be the key barrier to entry in the European capital markets. In some European markets tax relief or reclamation can be done very quickly, but in other markets the process takes years. There are many other similar issues for investors, such as depository passporting, all of which sit under the Capital Markets Union (CMU) banner.

An IFI representative underlined several key measures to overcome uncertainty: clear, transparent and implementable regulation; risk sharing mechanisms which allow small amounts of public money to leverage large amounts of private money; investment in mitigation and R&D; and a deeper CMU to create a level playing field.

This final point connects to a much wider discussion about Solvency II and why the venture capital and scale up market in Europe is much weaker than it is in the US. In Europe, life insurance plans and pension plans are not allowed to invest in the venture capital market, as they are in the US. This is neither right nor wrong. It is not possible to have the market of the US with European social security protection and a European level of risk protection. These two paradigms cannot exist together; it is not possible to have the benefits of both.

2.5 Overindebtedness is a challenge, but there is no need to dilute EU fiscal rules

The Chair observed that all of Europe is overindebted. The solution to this might come from the markets, but there are also high levels of savings. Highly indebted economies will need to figure out how they can address huge challenges such as climate change, digitalisation and aging populations.

2.5.1 The need for international efforts

An official explained that countries in the global south often talk about being climate creditors as well as financial debtors. These countries want to balance the equation. This must be taken into account in terms of both the ownership of projects and avoiding the trade off between growth and decarbonisation. There must be bilateral and regional effort on this priority. There must also be a substantial effort on the global financial safety net. There is a role for the World Bank and the IMF to finance projects in regions that are heavily indebted. These countries still need investment to decarbonise.

2.5.2 The green transition can be achieved without diluting fiscal rules

An official stated that the Commission estimates that reaching the 2030 goal will require €600 billion per year. Meeting this need would require a reallocation of 1.8% of the EU budget. This should be considered before any other new instrument for financing. The responsibility of public budgets is to make the green transition socially affordable. Social spending in member states amounts to around 30% of GDP. Better targeting of this spending will create room to manoeuvre. The financing possibilities are similar in all EU member states, which means there is no need for extra funds and no reason to depart from EU fiscal rules. Green debt is a type of debt; it has to be borrowed from the markets and financed by people. If there is a credible greening strategy, there is no need for any kind of additional green debt.

The Chair noted that the EU budget is relatively small and not adopted along transparent, parliamentary procedures. An official suggested that half of the CAP could be reallocated for climate purposes.

An industry speaker observed that debt is one of the greatest inventions of humankind. Banks love debt, as long as it is paid back with interest. For that to happen, there must be cash flows that guarantee a borrower can pay back their debt. When it comes to the investments that need to be made, green investments must be helped and brown investments must be penalised. There will be a

need for a large amount of debt to facilitate the vast investments that are needed. If the debt is not paid back, the cycle will stop.

A policy maker emphasised that there are many economic studies and impact assessments behind the EU's climate policy. The question of capacity is interesting, but currently the force of economics is not very strong when it comes to predicting behavioural changes or catastrophe risk, both of which will be crucial in the next few decades.

It is also important to consider the issue of tax. In the past, individual taxes were designed as a form of sustainable revenue. The Commission now agrees with the IMF that, while some behavioural taxes in the tax mix should be stable, some taxes will be short lived. Behavioural taxes will be developed and changed as behaviour changes. Behavioural change must be taken into account by investors and policymakers. Eating habits will change; urban development will change; industry will change.

2.5.3 When NGEU expires, further action will be required to ensure the EU reaches carbon neutrality

An IFI representative emphasised that Europe must face this challenge together. NGEU has brought approximately €750 billion of funding for the green and digital transitions, along with €300 billion from REPowerEU. Once these expire, further action will be required to set

the EU economy firmly on its path to climate neutrality by 2050. There will need to be a budgetary mechanism that creates a level playing field. The costs of a global problem cannot be imposed equally on countries in different situations. There must be a just transition.

The question of debt sustainability does not take into account whether debt is green, yellow or blue. Without debt sustainability, the transition will not make sense. The transition path must bring resources to the sectors that need them. NGEU provides the means to fund these projects. Countries can use the NGEU money and the European Investment Bank (EIB) and other financial institutions can leverage it. NGEU only runs until mid 2026, but the transition will happen over the next three decades. For the next three decades, the EU will need to develop something else which attracts private money in the same way as NGEU.

An official emphasised that, from a European perspective, Next Generation EU (NGEU) is providing a huge boost to public investment. Over the next few years, it will be vital to develop a pipeline of game changing projects that will outlast NGEU and continue to leverage private capital from within and outside the EU while making the industry more competitive.