FINANCIAL TIMES

Climate experts' forum: Are financial instruments the right tool to help developing countries?

December 11, 2009 11:37 pm by FT Energy Source

FT Energy Source is posting a daily question for our panel of expert commentators. Below are responses from panel members Kyoto carbon markets architect Graciela Chichilnisky, Mindy Lubber of the Investor Network on Climate Risk, Jeremy Leggett of Solarcentury and Julian Morris of The International Policy Network.

Are derivatives and other financial instruments a good way to address the political issues around financing carbon reduction in developing countries? What are the risks and how can they be avoided? This refers not only to institutional proposals such as those offered by George Soros, but also market-based instruments.

Graciela Chichilnisky: Derivatives and other financial instruments can be an excellent way to address the political issues around financing – among OECD nations or between the Organisation for Economic Co-operation and Development and developing nations. Transparency, appropriate regulation and accountability are important of course.
Examples are the Clean Development Mechanism of the Kyoto Protocol, a financial mechanism that was explicitly endorsed by 100 nations at an April 27-28 2009 meeting in the Palais des Nations, Geneva, convened to evaluate it. The CDM is not perfect and needs improvements – but the consensus from the 100 nations that were present was that it was working. The carbon market itself – which I have designed and drafted into the protocol in 1997 – is a financial mechanism that has been successful in financial and environmental terms as well. It is now trading $120bn in the European Union trading system and has helped decrease the equivalent of 20 per cent of EU's emissions.

At present the main stumbling block in Copenhagen is all about financing – financing adaptation and mitigation needed for climate change, the costs of climate change to the most vulnerable nations of AOSIS (the Association of Small Island States) that may soon perish under the oceans if the process continues, as well as financing investments in abatement and new energy technologies.

The Soros proposal is difficult because it relies on the International Monetary Fund – an institution that is viewed as unfriendly to the environment and to poor nations. However, a $200bn a year fund that is raised from private funding but is underwritten by the OECD nations and uses as seed funds the already promised $10bn offered by the Commonwealth – and the $25 bn that is offered right now for deforestation and forest degradation – could do the job.

This fund will be successful if it has the support from the energy industry, for example, and it has as a purpose building power plants in developing nations that "suck carbon from air" as proposed recently by Dr Pachauri, the chief of the International Panel on Climate Change, and many others. This would be a win-win solution for industrialised and developing nations and the beginning of the new clean economy we are all hoping for. Time is tight.

Graciela Chichilnisky is the architect of the carbon market of the Kyoto Protocol and the co-author of Saving Kyoto.

Mindy Lubber: Since I'm American I'll open my answer with a staunch defence of the market instrument known as "cap-and-trade" at the heart of my country's current climate and energy policy proposals. It's a good idea, not only as to what works to move markets but, equally crucial, what works to move American politicians – and with them a Copenhagen consensus.

The latest evidence on the American side came yesterday when three leading senators – a Democrat, a Republican, and an independent – unveiled their "tripartisan" climate proposal which pointedly includes a cap-and-trade programme like the one that already passed in the lower House. We use it, said one, because it's a market-based system for reducing pollution.

Indeed it is. And we are taking our eye off the ball here if we fail to focus on both of its elements: the cap and the trade.

The "cap" part is getting lost in unwarranted histrionics about the "trade" part. I'll get to the latter in a moment, but let's not lose sight of this:*A cap is at the heart of good climate and energy policy and is indispensable if we are to make headway against climate change.*

That's why it's better than a straight energy tax: given the science, we must assure that emissions drop; an energy tax can't offer that assurance. So the US must have a cap and a meaningful one – America's will be a pace-setter for the world.

As to the "trade" part, I'll agree with Nobel-prize winning economist Paul Krugman's forceful argument that a trading system creates the same incentives, in the aggregate, as an energy tax – even for emitters "grandfathered" with free emissions allocations permits. That's because there's still a big incentive – money – tied to their actions.

And Krugman says carbon markets aren't the open door to Wall Street shenanigans some fear. "Emissions permits aren't subprime mortgages, let alone complex derivatives based on subprime," he says. "They're straightforward rights to do a specific thing. It will truly be a tragedy if people generalise from the financial crisis to block crucially needed environmental policy."

All that said, any international trading market – most certainly one for carbon emissions – should have the verifiable safeguards our mortgage-trading markets so famously lacked. Verifiable compliance with emissions commitments for all countries – developed and developing – is an essential building block of the Copenhagen process.

And well-designed carbon markets provide the most cost-effective way of achieving emissions reductions. That being the case, mechanisms for directing public and private financial flows to low-carbon development in both developed and developing countries must also be part of Copenhagen's consensus.

Once we have these market mechanisms in place all sorts of clean-energy markets and investments – in America and elsewhere – will get a well-deserved boost. Because fossil fuels' unfair market advantage will be removed.

Watch the investment money flow from there. That's the message so many global businesses and giant institutional investors are walking Copenhagen's halls to deliver, even as we speak.

Mindy S. Lubber is president of Ceres and director of the Investor Network on Climate Risk, a network of 80 US and European institutional investors with collective assets totaling $8,000bn.

Jeremy Leggett: Financial innovation is much underutilised in dealing with the climate threat, both at the micro- and macro-levels. At the micro-level, for example, it is still impossible in some countries to acquire even a simple mortgage with which to overcome the upfront capital cost of microgeneration. At the macro level, for example, there is considerable untapped potential for climate bonds.

How better to mobilise a low-carbon future rapidly than the large-scale issuance of long-term debt to overcome medium-term investment barriers to achieving economies of scale in manufacturing? How better to find a way for pension-fund trustees to manoeuvre around the current dysfunctional definition of fiduciary responsibility?

So dysfunctional is the focus on short-term returns that many pension fund managers are forced to invest in carbon-intensive stocks knowing that they may be fuelling net wealth destruction via climate meltdown <in the long term, conceivably just as the time the pension holders come to need their retirement income. All it would take to change this, and unlock and divert multiple trillions of the peoples' money currently bankrolling climatic ruin, is for government, industry and investors to sit down and thrash out the necessary bond architecture – just like the Victorians did when they decided to build the sewers.

It would be rather simple for the parties, given the will, to decide how best we use the returns on investment from the lower energy prices reaped from low-carbon technologies in the future in order to provide price support investment for genuine "green new deal" manufacturing and services-provision today. A rather small group of forward-thinking governments, corporations and institutions could do it outside the full intergovernmental process, and by exercising such leadership, greatly influence that process.

Derivatives could of course be a part of such a financial innovation narrative. But there should be one big proviso. If governments get serious about climate change and ensure the necessary high-price regime for carbon with caps that work, the market will become incredibly attractive to the investment banking sector. At that point, as things stand, super-greed-driven bonus-cultists will zero in on it. By this I mean the class of banker that recently visited ruin on so many during the financial crisis. Because of their excesses, millions are unemployed today who wouldn't have otherwise been, perfectly viable SMEs still cannot find credit, and the world still hovers on the edge potentially of a W shape, not a V shape, in its recovery from recession. The bonus cultists, meanwhile, have been allowed back into their casinos, after just a few months on the naughty step, with barely a slapped wrist. And they are now gambling afresh, this time even more safely underpinned by the peoples' money.

If we unleash this class, lightly unregulated, into the carbon markets of a world genuinely having a stab at a climate survival reflex, we would surely live to regret it. They need to be reined in first, as so much of the commentary in the Financial Times has proposed of late.

Jeremy Leggett is an author, founder and executive chairman of Solarcentury, a solar energy company, and ambassador to the Global Observatory at Copenhagen.

Julian Morris: Given that climate change is a long-term threat, it makes sense to use long-term credit markets to address it. So, for example, companies could issue zero-coupon contingent 'climate change bonds' which would pay out only if specific defined consequences were to materialise. The companies issuing these bonds would have incentives to prevent the consequences materialising – using the money raised from the bonds to pay for whatever is deemed to be the most cost-effective strategy. The bonds would trade in secondary markets, with prices varying according to the assessment by market participants of the probability of the consequences materialising. Plausibly, derivatives of the bonds might also be constructed. And the bond issuers might insure themselves against having to pay out, thereby transferring some or all of the risk of paying out – as well as the incentives to address the threat – to the insurer.

Julian Morris is an economist, author and director of The International Policy Network.

Tags: Copenhagen
Posted in Emissions | Permalink