The Ideas Exchange from Brussels

Squaring the Circle:
The transition to net zero in an era of inflationary pressure

As part of an ongoing BlackRock event series exploring key questions and challenges facing Europe today, the recent Ideas Exchange from Brussels focused minds on how to achieve a green transition in a new era of entrenched inflationary pressure.

Europe is currently grappling with the trade-offs between short-term priorities – ensuring energy security and managing inflation – and long-term goals of achieving a carbon-neutral continent. It was precisely this balancing act that became the central part of the discussion; how can policymakers, stakeholders, and the global economy navigate current political and economic realities to continue pursuing a green transition?

Compounding crises: what impetus for net zero?

Isabelle Mateos y Lago, Global Head of the Official Institutions Group at BlackRock, opened the session highlighting Europe’s role as a pioneer in decarbonisation. The EU was one of the first international bodies to pledge carbon neutrality by 2050 and aim to halve emissions by 2030. But the focus is now on implementation: undergoing the massive reallocation of resources needed for the fundamental transformation of Europe’s industrial model.

The economic recovery from the Covid-19 pandemic has cast a long shadow over Europe’s fiscal outlook and drew into sharp relief the real-life potential for environmental degradation to endanger its population. But rather than being a setback for the transition, the global crisis acted as a driver to accelerate EU action for greening the economy, with NextGenerationEU funding as the key mechanism.

Today’s reality of soaring energy prices, supply chain disruptions and mounting geopolitical pressures has however exacerbated this challenge, highlighting Europe’s vulnerabilities in energy security and heightening the inflationary pressures sparked by the pandemic. Crucially though, panelists agreed these challenges have only reinforced the need for long-term investment in renewables to achieve a net zero transition.

Navigating a transition path which is no longer linear

In this new context, panelists discussed the current geopolitical balancing act which has complicated Europe’s path to net zero.

Marco Buti, Head of Cabinet to Commissioner Gentiloni, stressed that securing energy supplies and reducing the

My takeaway from this discussion is that there is no desire [from the public or private sector] to deviate from the ultimate objective. It will be tough, requiring more public intervention and more spending than perhaps would have been initially anticipated due to the new constraints, but I am encouraged that you all seem to think that it’s imminently manageable.”

Isabelle Mateos y Lago, Global Head of the Official Institutions Group
The big question is from a policy, institutional and also from a political perspective accepting the non-linearity of fossil fuels. It is obviously very delicate. There is the trade-off one has to manage between accelerating the green transition and at the same time reducing the dependency on Russian energy sources. The key issue is not to call into question the ultimate goal of decarbonisation.”

Marco Buti, Head of Cabinet to Commissioner Gentiloni

continent’s dependency on Russian imports was currently top of mind for Europe. Europe’s RePowerEU Strategy aims to achieve this by accelerating investment in renewables, while turning to non-Russian sources of fossil fuel-based energy over the short term. It was the need for non-linearity that the speakers encouraged policymakers and stakeholders to reconcile.

Jean Pisani-Ferry, Chair of the European University Institute and Senior Fellow at Bruegel and the Peterson Institute, suggested that although public spending on fossil fuels should help secure Europe’s energy supplies in the short term to enable greater EU energy sovereignty, decarbonisation should remain the priority. The private sector then should continue to strive for decarbonisation and invest more heavily in renewables which make greater economic sense as long term investments.

Carole Crozat, Head of Fundamental Research at BlackRock Sustainable Investing, expanded on the investor perspective, highlighting the need for investors to understand that in the long run, it is less inflationary and disruptive to invest in the transition than to leave it for later. Crozat emphasised the Ukraine crisis’ erosion of the so-called Green Premium, whereby heightened energy prices are mitigating the premium investors are paying for green assets. However, she noted the importance of practicing caution around this development, as potential short-term measures to promote fossil fuels in Europe can exacerbate the risk of stranded assets once the effects of current geopolitical tensions abate.

**How to distribute EU, national and private sector investment**

Europe has set out the necessary goals and targets for its green transition and energy sovereignty, the question now emerges around how these financing needs are met in practice. To meet Europe’s underlying target to reduce carbon emissions by 45% by 2030, Buti stressed that Commission modelling estimated EUR 390 billion worth of annual investment is needed, which amounts to an increase of investment-to-GDP ratio of roughly 2%.

Pisani-Ferry cast doubt over the utility of setting rigid ratios across investment needs at EU level, national governments and the private sector. He stressed that current estimations calling for one-third of investment being supplied by the public sector, with the remaining two-thirds covered by the private sector, should only serve as general guidance for policymakers, rather than firm policy.

At EU level, Buti noted that there is still substantial headroom in a number of the EU’s upcoming and ongoing financing initiatives. In the EU’s Recovery and Resilience plans, 37% of funding will be dedicated to the green transition, while there remains EUR 220 billion worth of loans still to be accessed in the NextGenerationEU framework.

Pisani-Ferry suggested that the EU facilitates investment via potential modifications to the Stability and Growth Pact (SGP), where one of the objectives in the upcoming negotiations will likely be to provide for a green investment incentive framework.

**Securing the right incentives**

To achieve the radical overhaul of Europe’s economy, panelists explored what incentives were needed. Crozat framed the question for investors around three main drivers of green investment: (1) understanding what consumers’ preferences will be; (2) mapping the differences in capital costs for incumbents compared to new technologies; and (3) what kinds of environment-specific policies will come out of public authorities.

“**Most crucially, the costs of environmental externalities will need to be internalised. To date, our economy has been wired to maximise growth and minimise costs, but now new objectives must be considered, such as resiliency, security and long-term sustainability, and for that to happen the cost of the destruction of natural capital and other environmental assets such as a stable climate need to be factored in.”**

Carole Crozat, Head of Fundamental Research at BlackRock Sustainable Investing

On wider policy incentives, Crozat and Pisani-Ferry agreed on the need for a long-term planning approach for issues such as energy subsidies, carbon pricing and large-scale industrial and infrastructural development projects, as a
means to ensure adequate certainty for investors providing capital for the long term. As of yet, policymakers may not have provided this certainty for investors, and this would need to be resolved in order to unlock private capital for the future.

By way of example, Buti elaborated on the Carbon Border Adjustment Mechanism (CBAM) proposal as a prime example through which taxation, pricing and regulation can be used to ensure the smooth allocation of capital into sustainable assets – avoiding the risk of carbon leakage.

**Squaring the circle**

Marco Buti identified the optimisation of four elements, namely, allocation, redistribution, stability and security, as the key to square the circle.

Finally, Isabelle Mateos y Lago brought the roundtable to a close noting the clear agreement among panelists that Europe’s goals for 2050 are still a top priority, but that indeed the path to a carbon-neutral Europe is no longer linear. The net zero transition will require more public intervention and spending than initially anticipated, but, crucially, it will be manageable. Investment from Europe, national governments and the private sector will all be needed in parallel to achieve energy security, control inflation and achieve a just green transition.

> Climate policy is suffering from a major credibility problem, private investors need to know the price of carbon not just today and tomorrow, but 10 years from now... We have to recognise that the idea that prices will drive the transition is in part an illusion. The idea that governments should not get involved is wrong [...]. The reality is different... [prices] are still needed, but this needs to be combined with regulation.”

Jean Pisani-Ferry, Chair of the European University Institute and Senior fellow at Bruegel
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