Making the Financial System Sustainable

The EU Action Plan on Financing Sustainable Growth is the most advanced and comprehensive policy agenda on sustainability in the world. But is it going in the right direction? Acting as a bridge between policy and academia, this up-to-date contribution to the global policy debate brings together some of the leading experts from the European Commission's High-Level Expert Group on Sustainable Finance, to discuss how the financial system needs to be reformed to promote sustainability. Finance has long been criticised for being short-term focused and concerned with maximising returns to intermediaries, rather than with the interests of savers and borrowers. The financial system must now take into account environmental, social and governance considerations to support a sustainable economy and this volume offers new insights on the way forward. Essential reading for anyone working on financial sector policy and sustainability.

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Foreword

Sustainable Finance and the Need for a 'New and Sustainable Globalisation'

by Christian Thimann[1]

Rarely has a topic gained global prominence as fast as has 'Sustainable Finance': the integration of long-term sustainability goals, including climate, into financial decision-making. The aim is to support the economy on a path that maintains employment and welfare in a way that is sustainable in the long-term.

The Paris Agreement, reached at the Conference of the Parties 21 (COP21) on climate change in late 2015, laid the basis for the sustainable finance agenda. For the first time in twenty years of this annual conference, the financial sector was mentioned as playing a role to help bring more investment into decarbonisation. In 2016, a majority of the signatories ratified the agreement at national level and the threshold for global implementation was passed. In 2017, the European Commission launched a High-Level Expert Group on Sustainable Finance, which I had the privilege to chair and whose membership included many contributors to this book, including the editor.

The group presented its report in early 2018, and the European Commission built its Action Plan on Sustainable Finance only a few months later, largely inspired by the group's work. Implementation started whilst the group continued to meet, based on a broad-based recognition of the issue among the financial sector at large as well as the supervisory, and ultimately the central banking community. By the start of 2020, one can safely say that sustainability issues, regarding climate change and other long-term objectives, had been

[1] Chair of the EU High-Level Expert Group on Sustainable Finance and Vice-Chair of the FSB Task Force on Climate-related Financial Disclosures (TCFD). Views expressed are personal.

'mainstreamed' in the financial system. From niche to mainstream in less than five years—a remarkable achievement.

The second remarkable aspect about sustainable finance is that it is ultimately science-based, at least when relating to climate change. It is the natural sciences that have measured global warming and sea level rise, qualified and quantified greenhouse gas emissions and developed a metric for the trend in total emissions to keep climate change in check. There are not many instances where the work of the natural sciences has fed into financial regulation as rigorously as for climate change.

With great prominence comes great responsibility. It is a huge task to finance the transformation of the global economy towards lower emissions and generally a much more environmentally responsible functioning. The implications go far beyond the energy and even the transportation sectors; a far-reaching decline in global CO_2 emissions will only be possible if there is change along the entire process in which goods are produced, transported, consumed and disposed of in the global economy.

We will soon realise that the biggest 'climate killer' is not coal, as is sometimes postulated, but the way in which globalisation has been pursued. The globalisation that we have witnessed over the past three decades has incurred a shift of production towards geographical areas with weaker environmental and social standards; it has also pushed to the extreme the focus on maximising the profits from consumption through low production costs with disregard to all areas of sustainability; and it has led to an astronomic rise in global transportation of all sorts: people, raw materials, unfinished goods and finished goods, creating massive emissions, pollution and environmental damage.

The environmental damage is most visible in the emerging economies where a large share of the production destined for final consumption in developed markets has been located; this has been a high price to pay for the income rise in these economies. And western Europe has witnessed the social damage of this globalisation in terms of structural unemployment and desertification of entire regions – think of Southern Italy, many regions of France, Northern England or Eastern Germany, to name just a few.

At the same time, however, this globalisation has boosted economic development in emerging markets in a speed and breadth never seen before. This is the positive side of globalisation, and this is also why the solution cannot consist of backtracking on globalisation as such. The solution cannot be protectionism or autarky; the solution is a *different globalisation* as suggested below.

To correct some of these trends and arrive at a sustainable manner of global production and consumption will be a herculean task, for European policy makers and others alike. Europe has much to gain from taking sustainability seriously but could also lose on both environmental and other economic grounds if the process is not well handled. The following paragraphs explain the reasoning.

* * *

Sustainable finance is, first of all, a call on the financial sector itself to change its functioning away from a short-term focus towards a long-term orientation. Financial speculation, short-term profit extraction, betting on (and hence forcing) corporate distress by way of short-selling, must be brought in check much more resolutely than has been the case so far. There are too many pockets in the financial system that are on a monthly, quarterly or annual performance cycle and push the real economy towards similar performance cycles. We cannot build a long-term future while focusing on swings in quarterly earnings. And none of the new ESG-disclosures demanded from the real economy will help if the financial sector is unable to process them properly.

The changes towards sustainability and long-term orientation are necessary in particular for the structure and functioning of financial markets; specifically, the stock market and corporate bond market. There is far too much short-term profit seeking in trading of stocks and long-term bonds. The market economy does not need stock prices changing by the minute or by the nano-second. It may even be seen as unethical to trade people's jobs by the minute and pretend that the value of a corporation with tens of thousands of employees should be re-priced several hundred times per day. In economic terms, such price fluctuations are meaningless, and for sustainability they are poisonous. In contrast, much less change is necessary as regards banking, insurance or pension funds as these institutions in Europe are already today strongly focused on the real economy and on long-term welfare generation.

* * *

For the European economy, three issues must be kept in mind.

First, global CO_2-emission targets are science-based, but national targets are not, and neither is the European Union (EU) target. National targets and the EU target are the outcome of negotiations that took place in Paris. Here, the EU and its Member States promised a much deeper decline in emissions – namely of 40% over a few decades – than other developed economies (for example, the US promised only a 10-15% cut before stepping out of the Paris agreement altogether). China will continue to increase CO_2 emissions until at least 2030. The EU must remember that great ambition comes with great risks, because such an emissions reduction is not possible with today's technologies other than through a massive cut in European economic activity, which would have huge and possibly unsustainable consequences. The EU emissions reduction path is only economically and socially sustainable if it remains open to new technologies, while keeping jobs and production in Europe.

Second, the easy answer for the EU would be to lay on top of the European financial and real economy industry yet another layer of rules and regulations that would be so strict that it would severely constrain economic activity on the continent. Already today, the European economy is the most tightly regulated economy in the world. This is not just true for banking and insurance, but also for agriculture, telecommunications and many other sectors. Sustainable finance must not simply create an additional layer of regulation but should lead to a *change* in regulation – or even just a change in how it is applied – to promote sustainable outcomes. Ideally, it would lead to far less complex regulation, as the single overarching objective of sustainable economic development is unambiguously clear.

Europe is one of the continents with the cleanest, most environmentally friendly industrial production processes. Therefore, if Europe were to raise standards unilaterally and further regulation were to lead to the delocalisation of industrial activity outside of Europe, this might seemingly help towards Europe's extremely ambitious CO_2 emissions targets. But actually, it would be net negative for the global climate to the extent that production is just moved to more polluting locations and it would diminish Europe's remaining industrial base, which carries millions of jobs and the European welfare system. Such a strategy would have economic costs for the EU and environmental costs for the planet.

The experience of the delocalisation of the European steel industry to other continents is a case in point: when steel factories in France, Germany and other countries were dismantled and rebuilt in the far East, the desulphurisation facilities were often left behind. The global environmental impact was severely negative. Therefore, sustainability should lead to a *re-localisation* of part of the activity that was lost. Such re-localisation to Europe would improve environmentally friendly productions, reduce transportation and lower global emissions. Europe should *favour* economic activity *in its own regions* and focus on local, sustainable production rather than global, unsustainable production. 'New and sustainable globalisation' would favour local production wherever possible, and imports from far around the globe would be the exception and not the rule. 'Sustainable Finance' should therefore have a spatial dimension. Vicinity matters, and proximity is preferable.

It is simply against common sense that Europe has its shoes, textiles, household goods, household appliances, stationery, basic machinery and tools and a rising share of food imported from locations thousands of kilometres away. What has led to this outcome? Economics and non-sustainable finance have played a key role in driving this process by focusing on short-term monetary returns at the expense of social and environmental costs in both the production country and the European Union.

A key concept is the one of 'comparative advantage' postulating that differing relative costs of production within a country favour specialisation by each country and international trade. While conceptually appealing, the argument has two shortcomings.

The concept of comparative advantage overlooks transportation costs including environmental costs, and it overlooks size differences and market power. It is best to illustrate the latter point with the economic development in the country of origin of the inventor of 'comparative advantage', David Ricardo. Ricardo's family was originally from Portugal and emigrated to England. His father became wealthy as a stockbroker in London, and David Ricardo developed theories on international trade.

English officials made heavy use of his argument of 'comparative advantage' in the second half of the 19th century to convince Portugal to open its domestic market on a large scale through advantageous tariffs to English industrial goods. England was seeking market access for its booming industrialisation. In exchange, Portugal would export Port wine, as the theory had famously suggested.

What was the result? The Portuguese economy was provided with cheap industrial goods from much larger England, practically wiping out any existing and nascent industrial activity in Portugal. The economic impact was devastating: before this opening occurred, around 1860, Portuguese per capita GDP was 75% of that of France and supported by industrial activity in textiles in particular. By 1910, this share had fallen to 13% and industry was virtually absent in Portugal. There is little doubt for economic historians, that this broad opening to trade with a much larger economy was the main reason for late economic development in Portugal, famously called 'le retard Portugais'.

Replace England with China and Portugal with selected EU regions, say in France or Italy, respectively, and the economic consequences become visible again. Consumers in these regions are flooded with cheap industrial goods from China and other Asian emerging economies, but domestic industry and employment have been massively diminished. The only difference to the historical example is that these regions do not export Port wine, but tourism services to a fast-growing number of tourists from China and other emerging markets.

This is why the EU's Sustainable Finance should focus in particular on fostering local and regional activity within Europe, for the economic and social benefit of the EU and for the environmental benefit of the planet. In this way, it would support the 'new and sustainable globalisation'. The benefits of such new and sustainable globalisation for emerging markets would remain: they would still have access to all technological progress available, but not so as to destroy their own environment in favour of mass production for developed countries.

Third, getting the pacing right on implementing sustainable finance, and climate polices more broadly, is critical. Regulatory changes can steer industry but must not be so fast that European industry does not have the time to adjust. It would not be the first time that abrupt policy changes had wiped out entire European industry sectors: it happened to the photovoltaic industry after the EU opened abruptly to massive imports; it happened to the lighting industry after the EU set up lightbulb regulations and demanded a quick shift towards halogen and then LEDs that now almost exclusively come from China. As a result, Europe lost jobs and product prices rose sharply. These may seem very specific sectoral examples, but developments in the energy, car manufacturing, machinery, technology and digital sectors are also worrying.