Discussion of **“Climate Policy and International Capital Reallocation”** by Fourné and Li

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BIS, December 15, 20203

Climate policy effects on investments: my intuition

Climate policy

- is either a constraint or a tax => higher cost of production, immediate capital costs of compliance
- is signal of government's commitment to sustainability => may indicate future climate policies => future higher cost of production
- is a resolution of uncertainty (transition risk) => may encourage investment
- is a wedge between domestic and foreign regulatory environment => may be a barrier to capital flows
- May include incentives for green transition => may increase demand for investment

Climate policy effects on investments: my intuition

Investment

- increases with higher future profitability
- declines with higher uncertainty or risk
- responds to incentives (such as “green” incentives)
- transition risks can be diversified through green investment
- is subject to diversification motives

Climate policy in source country

- may increase outflows if investors expect reduction in domestic future profits
- may reduce outflows due to
  - resolved uncertainty
  - increased domestic demand for investment needed in the short run for compliance
  - domestic “green” incentives
  - increased regulatory differences (Dijkstra et al., 2011; Ni et al., 2022; Sasidaran et al., 2023)

Climate policy in target country

- may reduce inflows if investors expect reduction in future profits
- may increase inflows due to
  - resolved uncertainty
  - increased demand for investment needed in the short run for compliance
  - “green” investment incentives
- may reduce inflows due to higher regulator differences (Dijkstra et al. , 2011)

What this means

- Need a framework for climate policy effect as it can be ambiguous
- Long run and short run effects might be different
- Type of climate policy matters (applied to financials or non-financials?), taxes/constraints vs. subsidies/incentives
- Future path of climate policy matters
- Sectoral composition of investments might be affected (total flows might be unchanged but there might be sectoral shifts)

Not expecting one paper to answer all these questions

This paper: focus on international investment

- FDI
- Portfolio: equity and fixed income
- Bank loans

In response to both source and target countries' climate policies

The measure of interest is change in bilateral flow *share*

I think adding exports is quite confusing because mechanism is quite different. Perhaps, controlling for exports instead? Since trade can affect financial flows.

Findings: differences across asset classes

- Increase in equity and bank loan shares in response to target countries' policies
  - Interpreted as a diversification (no test of the mechanism)
- No effect on FDI and bond flows

Results are driven entirely by AE -> AE flows (Table 4)

Also evidence of: negative response of FDI with longer delay (Fig. 3), negative response of equity flows from AE to EME (Fig. 4)

Unanswered questions

- **Do climate policies affect total flows in each asset class?**
  - Cannot answer this by looking at shares and all the FEs
  - Robustness test (Fig. 5) suggests maybe (but still fixed effects)
  - Try a specification that allows for differences *across countries* to affect the results (even if no causal interpretation)
- **Is there substitution between asset classes?**
  - Especially FDI vs. portfolio equity and bank vs. portfolio debt
  - Paper claims *joint* analysis of all types of flows as a contribution, but there is no joint analysis
- **What drives the effects?** Some tests of mechanisms that may differ across asset classes and may explain the results

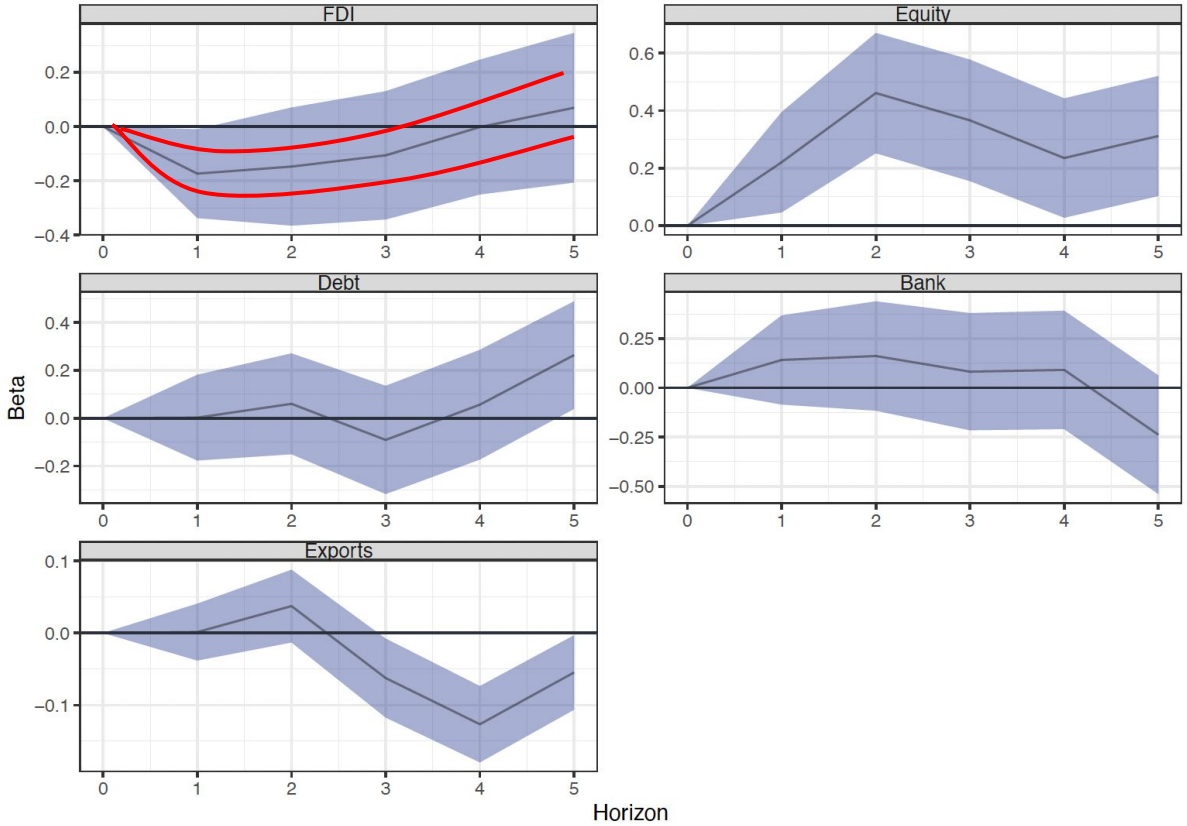
Main suggestions

- A number of papers predict that difference in policies is the main driver of flows, try to use that in the RHS (CP_target - CP_source)
    - This is similar to using interest rate differential
- Alternatively/In addition: since main results are about target, estimate non-bilateral results, which will allow to test for true nationality using BIS IBS Consolidated data and BOP data for target countries (can cover more countries for bank flows)
- Given that local projections show dynamics, include L2 and L3 of climate policies in regressions (or total change over 3 years)

Local projections

- Common to use 1 s.d. : Different finding re FDI
- Use the same scale

Figure 3: Local Projections



Potential remaining specification issues

- Short panel with a lot of fixed effects => concern about spurious results
  - Placebo test: reshuffle climate policy variable
- FDI (and other flows ?) may affect climate policy : direct endogeneity that can bias results towards finding a positive correlation
  - Cole et al. (2017) survey shows endogeneity materially affects results
- Policy interest rate is included, but ZLB most of the sample - try 2-year rate?
- Literature shows many changes after Paris (After 2016) in response of asset markets to climate risks. D(after 2017) may capture this as well as US withdrawal from the agreement - hard to interpret (***how to explain negative effects on equity?***)

Other questions/concerns

- In the Germanwatch calculation of CCPI are emissions scaled by country size? Size matters for capital flow shares. Probably not an issue with FEs, but might be worth checking
- Is there high correlation between climate policy measures and CO2 intensity? Would be interesting to see results with CO2 intensity only
- I would not include Table 5.
- Tables 8, 12 are hard to interpret given that many policies can come in packages (e.g. carbon tax + technology subsidy) and policies and performance are likely to be highly correlated (hence opposite signs of the effects)

Conclusion:

- Great ambitious paper
- Extremely carefully executed and well written
- Could be more focused
- Could add depth (substitution, mechanism) by reducing breadth (drop exports)