

Per Callesen: The role of financing and regulation amid broader policies to mitigate climate change

Speech by Mr Per Callesen, Governor of the National Bank of Denmark, at the Green Climate Fund's 2019 Private Investment for Climate Conference, Seoul, 8 October 2019.

* * *

Thank you for the invitation. It is good to be back at the GCF. 2011–2014, I served as a member of the Transitional Committee and the Board. Today, I will focus on the role of financing and regulators in the context of broader policies to mitigate and adapt to man-made climate change.

This past year has seen stronger engagement in climate issues around the world. This is most welcome. There has been better engagement by the financial industry. Central bankers and financial regulators are now involved in addressing climate-related financial risks. The climate challenge is so large that all players in our economies, all areas of policy, and all countries in the world will have to deliver and push in the same direction.

We need to be aware of the context. Others are better placed to consider developments in emissions and the setting of targets for future reductions. My perspective is the policies needed to meet objectives.

I remember the early 1990s, almost thirty years ago. We understood the climate impact of CO₂ emissions, and we began assessing how economic scenarios affected emissions. The policy implication was pretty clear: Announce a credible path of gradually increasing carbon pricing to set expectations right without affecting already undertaken investments by firms and households too much. That has not happened.

An appropriate pricing of fossil fuels, in line with the true costs of CO₂ emissions, would still be the most efficient driver of the needed climate-friendly innovation, investment and behavioural change of billions of people and hundreds of millions of firms. That behavioural change is needed to incentivise the rolling out of existing and upcoming technologies. We need more information on policies setting emissions, country by country. But we know that the current average direct global price of carbon is 2 USD per ton, approximately zero. Only about 20 per cent of global greenhouse gas emissions are covered by a carbon price. Only a fraction hereof is priced at levels consistent with the Paris Agreement. The price of most CO₂-intensive products, such as oil, gas and electricity, etc., is in some cases raised by close proxies of direct carbon pricing, such as fuel taxes. In other cases, the price of such products is reduced by fossil fuel subsidies. Likely, the net impact of taxes and subsidies is close to zero.

The absence of any significant carbon pricing has implications. First, it will be significantly more difficult to cut emissions in the absence of spectacular technological advances, which we yet have to see. Second, in addition to the cost implied by physical effects of climate change – such as flooding and droughts – the economic cost of mitigation will be substantially higher than if driven by price incentives. Regulated energy and emission standards have a significant potential, but are less efficient. Third, we have to hope, if we do not promote, that technological advances have a climate-friendly bias. This may well have been the case in recent years as the costs of renewable energy and energy savings have come down substantially and are now competitive. But many of us underestimated the technological advances also taking place in the extraction of fossil fuels, such as shale gas and deep water drilling.

As regards financing, climate-friendly investments would have been more attractive in a world of appropriate pricing and regulation of carbon. The absence of such policy action implies that we cannot expect financing to deliver as much as we would like. Attracting financing on a large scale requires a strong enabling environment. Investors seek the highest risk-adjusted return. But the

financial sector and financial authorities can and should nevertheless complement the fight against climate change, also with current public policy settings.

What are the opportunities from the financial sector perspective? First, lots of profitable climate-friendly investment projects exist already. Some on a large scale. In my country of origin, Denmark, we have numerous encouraging examples of companies and institutional investors contributing to and benefiting from the transition to a low-carbon economy – both at home and abroad. Others on a small scale; simple efforts to save energy in households and firms. Note that the low interest rate environment has shifted the investment balance in favour of upfront efficient capital and against outlays for energy year after year. Second, the financial sector has to care about reputational risks. It will get questions from customers and the media. Banks begin to check companies for their ESG strategies before lending, out of concern for both risks and reputation. Third, the financial sector should prepare for potentially stronger climate-friendly policies set by governments down the line.

Obvious and profitable climate-friendly investment needs often exist in areas of the world with difficult physical, economic or regulatory environments. Such barriers can be reduced with technical assistance. These are areas where also the GCF and other international financing institutions can have an important positive impact. I am encouraged by what I have learnt about the GCF activities since I left in 2014, and share the strong plea that all countries scale up their support for the GCF.

What is the role of central banks and financial regulators as regards climate change issues? The Network for Greening the Financial System, NGFS, is a recognition of the need for global collective leadership and co-ordinated action to effectively mitigate and adapt to climate change. Central banks and financial supervisors take part, and my central bank is a member. We are in particular aiming to improve our understanding of how climate-related risks may impact the financial system and the wider economy. Many questions have yet to be answered, but we are working to map the implications of climate change to better safeguard the financial system against these risks.

Climate-related risks are unlikely to be sufficiently reflected in financial balance sheets and asset prices. This is the case for both physical and transitional risks. Physical risks relate to for example droughts or flooding, while transitional risks arise from policy changes and technological advances which may inter alia shift the prices of assets, leaving some stranded. By nature, the impact of transition risks will increase, the more abrupt the transition to a low-carbon economy takes place. The longer we delay, and we are very late by now, the more abrupt these changes will have to be. The more abrupt change, the more pronounced the potential effect on the financial system. Risks should be addressed prudently from a financial stability perspective. Neither green nor brown investments and loans should receive special treatment which would undermine the credibility of risk weights. Rather, we should ensure that exposure to actual risks from climate change and the necessary climate-friendly economic restructuring is correctly accounted for. This would also send a strong signal to those who seek finance for their activities.

In conclusion, none of us – neither in the public nor private sector – can afford to overlook the risks associated with climate change as well as the need for immediate and effective policies and action. The financial sector can supplement fiscal and energy policies to fight climate change. But be careful that those who set fiscal and energy policies do not come to think that financial institutions, central banks and supervisors can substitute for their efforts. We all have to push and pull in the same direction. Thank you for your attention. I am looking forward to engaging with all of you at this conference.