Transcript of the interview with Ugo Panizza (Graduate Institute of International and Development Studies, Geneva) – July 2023

Caterina Rho:

Good morning everyone, and welcome to our second interview with top sustainable finance scholars in the context of the European Commission Sustainable Finance Research Forum. My name is Caterina Rho, I am the Secretary of the Forum, and today I have the pleasure of speaking with Professor Ugo Panizza. Thank you very much Ugo for accepting our invitation!

Ugo Panizza:

Thank you, Caterina.

C.R.:

I will give a very short introduction of Ugo. Ugo Panizza is Professor of Economics and Pictet Chair in Finance and Development at the Geneva Graduate Institute of International and Development Studies. He is Vice President and Fellow of CEPR and Fellow of the Fondazione Einaudi.

He is also the Director of the International Center for Monetary and Banking Studies, Editor in Chief of Oxford Open Economics and International Development Policy, and Deputy Director of the Center for Finance and Development.

Today, Ugo, we will discuss about the linkages between sovereign debt and sustainability. My first question is about this. There is a consensus about the fact that climate action is essential. However, to finance green policies, we need significant public investment. Often the countries more in need of climate investment are also those that present the most limited fiscal space. In your opinion, can climate sustainability and debt sustainability be reconciled? How should we design debt instruments to best support climate change?

U.P.:

Maybe we should start by thinking about two different types of investments that are needed. Mitigation investment, that is investment which is needed to reduce emissions and therefore to mitigate the climate change program, and then there is adaptation investment. Adaptation investment is required because climate change is already happening, and even if we move to Net Zero by 2030, which is not going to happen, or by 2050, the temperature will keep increasing for a while and countries will need to adapt to this new situation and spend money, for instance to build more resilient physical infrastructure.

Now, as I mentioned, Caterina, we can think that a lot of mitigation investment can be financed with private money, so basically we need to change our production structure, give incentives to private firms to do this. But adaptation investment is mostly investment in public goods, so better river banks, better ways to deal with floods and so on and so forth, and it will need to be financed with public money. The countries, which are more subject to climate risk, tend to be poor countries, which, they are poor so they have less money to invest, and they are already facing debt problems.

For instance, 60% of low-income countries are already at high risk of debt distress. So we have this two competing events, something needs to be done, and if countries are at high risk of debt distress so they do not have resources and most of adaptation investment cannot come with private money. So what do we need? We need a transfer of resources, we need a massive transfer of resources from richer to poorer countries and, in some cases, we need to restructure the debt that is to cut the debt of these poorer countries so that they can finance the needed investment in adaptation.

The IMF and the World Bank are rethinking their debt sustainability framework, the analytical tool that is used to see what level of debt is sustainable and whether the debt of a country should be reduced, to include climate risk. That will be the way forward for a country that needs to restructure its debt. The investment for climate adaptation and mitigation will need to be one of the factors to be considered in reducing this debt. I do not know if you want more details, this is a very broad overview of the topic.

C.R.:

This is very interesting Ugo, thank you very much. It is perfect to start. I have a second question that is linked to what you were saying. As you said, international organizations and governments are structuring new tools and lending instruments, but in particular, regarding countries' actions and governments' actions, can sovereign bonds be an effective tool, like green sovereign bonds for instance, to provide incentives for climate action? Or is this kind of green lending better structured for the private sector? What kind of incentives should a government have in mind to properly structure a green bond?

U.P.:

Very good. By the way, what I discussed before and what I will tell now, it is discussed in detail in… You mentioned my role of Director of the International Center for Monetary and Banking studies. The ICMB every year publishes something called the Geneva Reports on the World Economy, and last year report, which I coauthored with Beatrice Weder di Mauro, Lee Buchheit, Patrick Bolton, Jeromin Zettelmeyer and Mitu Gulati, focuses exactly on this point and we have one chapter on green sovereign bonds.

Our view on green sovereign bonds is kind of… not very enthusiastic, let me put it in this way, for two reasons. But there is something that can be done, and I will tell you about this. One reason is that, you know, debt money is fungible, it is a practical reason. When you have the budget of a country, the money comes in and it is very hard to say: "Oh, this money is allocated to a project." All the money gets together, it is fungible. There is this issue, money fungibility. Maybe I would have built this solar plant anyway, who is telling me that the [money raised with the] green bond that I issued saying that I would have used it to build a solar plant would go there? That is one issue. The other issue is more of a legal issue. Two of the

co/authors of the Geneva reports are lawyers, and lawyers actually read the contracts. Once you read these contracts, all these green sovereign bonds, it becomes clear that these bonds do not have any legal way to force a government to actually spend the money for green projects. Some of these bonds, there are many examples in the report, they are really saying: “We plan to use this money to finance green activities, however we are not committing to do this in any way”. So if you are going to buy a green bond and the country that issued the green bond decides to use the money to build a coal plant, it is not that you can sue the country and say: “Hey I gave you the money to build a solar plant, and now you are doing a coal plant!” The country can say: “Well, I told you that it was my general intention, but there was no commitment”. So, these are the two main issues with this type of bonds. What we think it could work better is what it is called sustainability-linked bonds. These are not bonds which focus on the use of funds. The typical green bond is: “Give me one billion and I will do something, I will build solar plants, or do something else”. Sustainability linked bonds are linked to outcomes. So I could issue a sustainability linked bond and say: “I am going to reduce emissions by X tons. And then the coupon, the payment of these bonds, is linked to me reaching these emissions. So if I indeed go below X tons, I will pay 3 percent, but if I emit more than what I promised, I will pay a higher interest rate, and if I emit less, I will pay a lower interest rate. In this case, the country, first of all, will really focus on the outcome we care about, which is the reduction of emissions, and second, there is a clear reward or punishment linked to reaching these emissions, so we think that this is a better way to do it.

C.R.:

Thank you very much, Ugo. This is very clear. So: sustainability linked bonds, not generic green bonds. You were also mentioning emissions and instruments to reduce carbon emissions. My third question will link to this. Other tools that have been already implemented to support the Green Transition are all tools aimed at directing investment towards green activities. In one of you recent papers you show that one of these initiatives, the EU Emission Trading System, is effective in raising the cost of capital for firms with high carbon emissions with respect to their green counterparts. This incentive scheme seems working for the EU case. Is the current setting enough for the EU, or should we push for further tools? Can the European model be extended to other countries?

U.P.:

First, let me spend a minute about the paper that you mentioned and then I will try to answer your questions. The paper that you mentioned is not a paper about sovereign debt but it is really a paper in which we look at private corporations, specifically we look at stock prices. The paper is joint with Martina Hengge and Richard Varghese who are both at the IMF, the paper was issued as an IMF working paper. What do we show in this paper? We show that when there is a policy, a EU policy decision, which leads to an increase of carbon prices of the EU within the EU emission trading scheme, the stock returns of firms with high carbon intensity, so firms that would need more [carbon], the price of the stocks of these firms goes down. This is equivalent to show that these policies that lead to a higher carbon price, tighter regulatory policies, reduce stock returns of these companies and therefore increase their cost of capital. This is important we think because it means that regulatory actions, which increase the cost of carbon, are particularly costly for high emission firms, and therefore these regulatory actions have redirecting

capital towards greener firms. That's the main finding of our paper. To answer to your question, first of all, is the EU trading scheme a good idea? Yes, it is. The European Union has been a leader in this, the first large economic area that set up this carbon-trading scheme. There were some growing pain in the beginning, you know, many of these emission allowances were given away for free, there were too many of them, so the price of carbon was very low, but with time the price of carbon has increased so it seems to be working. What it could be done, it could be extended. Now the emissions trading scheme only apply to certain sectors, to certain firms, I think it could be extended to more sectors, to more firms, so this effect would spill over to other sectors. Ideally, there is a nice paper by Patrick Bolton and coauthors showing that there are some spillovers that a multinational corporation which has spread both in Europe and outside Europe, tends to move the more emission intensive part of the production outside Europe to evade paying the price of carbon. It is clearly suboptimal because for the planet it does not matter whether the emission happens in Europe or somewhere else, what it matters is the total amount of emissions. One way of improving the scheme is to increase the global coverage, so maybe, I am not a big expert of the details, but maybe for global corporations it would be good to cover global emissions not just local emissions and of course this is a global externality. In a perfect world, we would like to have a carbon price that is global to avoid these kind of regulatory arbitrage in which high emission activities move to countries, which do not have carbon taxes.

C.R.:

Thank you very much Ugo! This was a very interesting discussion and interview on how policymakers, how governments can think about green investment, how they can structure green investment and which are the best incentives both from a public [sector] point of view and a private [sector] point of view. Thank you very much for your time. Goodbye to everyone, this is our last episode for the summer and we will see each other in September. Have a good day!