

# **Transcripts of the interview with Sony Kapoor (Schuman Centre for Advanced Studies, European University Institute) – June 2023**

## **Lucia Alessi:**

Hello everyone, and welcome to this new series of interviews with top sustainable finance scholars that we launched today in the context of the European Commission's Sustainable Finance Research Forum. My name is Lucia Alessi, I am the Chair of the Forum, and I have the pleasure of having here today Professor Sony Kapoor. Welcome, Sony! Sony Kapoor needs no introduction. After his paternity break, he will rejoin the Schuman Centre for Advanced Studies at the European University Institute as Professor of Climate, Geoeconomics, and Finance. He will also go back to his other role as Managing Director of the Nordic Institute for Finance, Technology, Sustainability, and Society. Thank you very much, Sony, for having accepted our invitation to open this new series of interviews on key challenges in sustainable finance. My first question for you is: are we actually underestimating the macroeconomic and financial significance and challenge of staying under two degrees?

## **Sony Kapoor:**

I think yes. First of all, thank you so much for having me and it's nice to see you again. Yes, I think we are massively underestimating the scale of the macroeconomic transformation, the financial challenge, and the political difficulties and trade-offs we will encounter in trying to stay under two degrees. One and a half degrees, sadly, we are already too late for.

Just to give a quick perspective of why I think so. As recently as last year, the NGFS came out with a baseline scenario of a smooth, orderly transition. I got in touch with them saying that it was several months after the Ukraine War, after our energy markets have been completely upended, there was so much economic volatility, so many developing countries were suffering because of inflation. How can we still say with a straight face that the transition will be smooth and orderly? The work I have been doing partly with the IMF, partly with other colleagues, and partly at the EUI was about what is the trajectory for the global economy over the next decade or so that may keep us under two degrees and as close to one and a half degrees as possible.

The scale of the challenge is highlighted by the fact that in order to be on the one and a half degree path, emissions need to fall between now in 2023 and 2030 by around 50% or so from current levels. Up until now, there have only been three years where global emissions have fallen, and only marginally. That was the global financial crisis, the fall of the Berlin Wall, and the Corona pandemic. All three occasions were accompanied by a great human suffering, massive economic and financial dislocation, and significant social and welfare cost to society. To say with a straight face, with that track record that we would somehow manage to reduce emissions by seven or eight percent, not just as a one-off, because in all three of those instances, emission bounced back after. To consistently year after year, continue to lower emission by 7% in a smooth way that will deliver growth without any massive political disruption... It is just very, very, very naive. The conclusion of the work we have been doing is that, within the next decade, the physical risks of climate change and our efforts to mitigate it will become the most significant drivers of the most important global macro-financial variables, including interest rates, inflation, size and direction of cross-border capital flows, cost of capital, fiscal deficits and fiscal balances.

Again, in 2023, to think of climate policy as an add-on or as an afterthought to monetary and fiscal policy and industrial policy, is completely outdated and makes absolutely no sense. Climate policy now belongs alongside fiscal and monetary policy as one of the three most important tools and analytical angles of global macroeconomic policymaking. That is where we have reached. That is why I think the current approach to policymaking, where still monetary and fiscal policy are the main tools, and climate policy comes somewhere down in the hierarchy, is completely outdated. It is the result of massively underestimating the scale and the scope of the challenge that we face.

### **L.A.:**

Thank you, Sony. Let me get back to one thing that you said. Essentially, the message is that reconciling growth and development with increasingly binding multiple environmental constraints is effectively the challenge of our times. Now, the question is: how can we possibly do that?

### **S.K.:**

Yes, that is the challenge of our times, and maybe it's worthwhile highlighting some numbers. This is the year of the Indian G20, and I know that the EU and India have been belatedly deepening their ties, as makes sense between the two largest democratic regions in the world. The choices for India are as follows. If India, with its 1.4 billion people, reaches half the resource intensity that China, with its 1.4 billion people, has today, then the world has already lost two degrees. If India reaches the same resource intensity that China has today, the world has already lost two and a half degrees. This is the macroeconomic, financial, and environmental significance of a country the size of India and the choices that it faces. To put it differently, the rest of the world, including the EU, which is prioritizing tackling climate change, and rightfully so, cannot afford for India to follow what remains till date, the only successful tried and tested development model of the last century like Japan, Korea, and China. That was an export led manufacturing growth model based on large-scale industrialization and huge physical infrastructure investments. India is the first large country that the world needs to follow a new development model that does not have the resource intensity, environmental footprint, carbon footprint, biodiversity loss, ocean acidification, all the other planetary boundary deterioration associated with the path that China took.

What does this look like? What is the development model that will allow India and Indian leaders to credibly promise their populations economic growth rates of 6%, to 7%, to 8%, increasing welfare and prosperity, material benefits, coming from near starvation, subsistence level agriculture for hundreds of millions of people in India, towards something that will be considered to be an acceptable way of living? Therefore India, in the absence of a credible new development model, has no choice but to follow the only tried and tested development pathway. That is the big geopolitical choice. The rest of the world cannot afford for India, and after India, for all of sub Saharan Africa with more than a billion people, to follow the Chinese trajectory.

Moreover, these countries, for their own citizens' sake, cannot afford not to do that. Is there a way of reconciling these development aspirations and needs with increasingly binding multiple environmental constraints that as of today are not just carbon? When the EU helps finance infrastructure in India, we do not want just that an infrastructure project does not have carbon emissions, we want that it does not only protect biodiversity but actually restores it. We want that the project does not pollute ground water, that there is no acidification of the ocean or runoff, that land does not get degraded, that tribal rights are respected.

All of this require more upfront capital. For the same unit of energy delivered or welfare delivered on unit of growth, a growth model that has all these multiple environmental constraints requires significantly more upfront capital than going down the Chinese trajectory, using domestic resources. Neither India nor any other developing or emerging economy have the source of domestic savings that would allow financing these additional capital requirements by themselves. This requires external support, including from the EU, the OECD, the US, countries that have contributed the most to climate change, and that support has not been forthcoming. That is the challenge we have. Without having a serious discussion about what the EU, the United States, the OECD can do for the emerging and developing world to offer them a new development model, the financial resources, the trade linkages, the technology transfers required to follow this new trajectory, we would continue to move inevitably towards a world of more than 2.5 degrees.

#### **L.A.:**

Thank you Sony, the message has been very clear. Now, let me focus on climate finance in particular. Wat do you think of the current risk-based approach that is now gaining consensus?

#### **S.K.:**

I played some role in this, having introduced the idea of climate stress testing for all institutional investment banks back in 2008, and I have spent years trying to mainstream it. I also did divestment work for a number of institutional investors, including the Norwegian Oil Fund, among others.

I regret my role in this, and my reasons are as follows. Individually sensible behavior by a financial institution trying to minimize its exposure to the physical risk of climate and to the policy risk of transition will not deliver us a world under 2 degrees. To get into that world we do not just require that money is taken away and withdrawn from investments in coal, oil, and gas, but we simultaneously require deploying significant amount of money in renewables, in circular economy models, especially in emerging and developing economies that have exponentially growing energy needs. The risk-based approach somehow contributes to the first part of the problem, but it does nothing for the second part: where are the tens and hundreds of billions of dollars been deployed in solar, in battery storage, in green infrastructure in sub-Saharan Africa and south Asia?

Just because a finance institution is risk-aware, if it is going to disown the problem, has it made a positive contribution toward investments required to tackle climate change globally? The answer is no. Individually sensible actions will definitely lead to collective disaster.

A second point is the broadness of the ESG discussion, where I was an early pioneer and I contributed to it. Roughly speaking, the environmental, social, governance standards one would expect in middle-income countries or low-income countries are on average lower. Data availability will be poorer and domestic firms will often be smaller. If we blindly apply ESG filters to European institutional investors' money, it immediately biases the financial landscape even further against developing and emerging economies where much more capital needs to flow. Very roughly speaking, when the most commonly used ESG filters are applied to something as mainstream and liquid as the MSCI global equity index, the weight of emerging economies instantly falls by about 20% or so. This goes back to the problem I mentioned. You are saying as the owner of the financial capital: I do not want to be associated with a company that has environmental problems and governments where there is corruption. However, what it really matters for global progress is the willingness to find companies and countries where your intervention, your capital, your expertise, your hands-on governance and engagement are, within a span of 3 to 5 years, registering one of the biggest improvements in ESG standards.

This discussion is relevant because we are interested in moving toward a world where the average ESG standards are higher. Instead, we are moving towards a world where the average standards are the same or even falling, but any institutional investor can say: look my portfolio has higher ESG standards now since I applied the filter than it did 2 years before. But have you done any contribution to improve the standards? The answer is no. By taking away money that has the capacity to engage and improve those standards, away from countries where the biggest improvements are required, you are potentially contributing to a worsening of the problem.

Regarding the third problem, I know that many of my colleagues are engaged with credit rating agencies. I also had conversations with them about getting Standard and Poor's, Moody's, and Fitch to become more climate risk aware and to start taking into account the imminent physical risk of climate into their rating process, which is well meaning, risk aware, prudential, prudent, sensible.

However, collectively the problem is that most emerging and developing economies are close to the tropical and subtropical zones, where the physical risk of climate is more immediately manifested and almost surely worse in the long run. Moreover, their financial ability to adapt to those risks are poorer, because these countries are poorer and have poorer infrastructure. This means that, on average, if the rating agencies started deploying physical risk of climate in their credit rating models, these economies would face a downgrade of 2 to 3 notches from just barely investment grade ratings or, in the case of many sub-Saharan African countries, ratings that are significantly already below investment grade. Investing in these countries with very low ratings is very difficult, very prudentially hard, discouraged by regulators, and supposedly risky. Once those ratings fall further, they would make these countries absolutely uninvestible. Therefore, this is an individually risk-aware sensible action, but it would collectively push the world over to 2.5 degrees because these countries need our technology, they need our capital to make choices that tackle climate change to choose renewables over fossil fuels. However, with even lower ratings than the current ones, we will find impossible to invest our money (that is already not flowing enough) there. Again, individually sensible actions will lead us toward a world where the one risk we say we are trying to avoid, climate change over 2 degrees, is the risk that it will certainly manifest itself.

#### **L.A.:**

Thank you Sony this transition finance discussion is crucial, and it is very close to the heart of the EU Commission. It is true that almost by definition I would say those companies that are riskier from a transition risk perspective they are possibly also those that are in need of transition, so in need of finance. Thank you very much to bring this up. Allow me one last question, and not an easy one! What could be a way forward for the global economy that delivers growth and development that meets critical mineral needs, it is financeable, and it also respects the environmental constraints that we mentioned?

#### **S.K.:**

This is the idea behind the interdisciplinary work program that I have been involved over the past 4 years, which tries to look at the intersection between the global macroeconomics, global finance, material flow and physical constraints, environmental constraints that go beyond just climate, development needs and geopolitical feasibility. I looked at all of these in various measures including for the Indian G20. I think we are extremely lucky to be in a situation where it is possible to deliver global growth while keeping us under 2 degrees in a manner that is

financeable, where material flows don't offer binding constraints, and which is geopolitically feasible, because there is something attractive there for each of the major group of countries. This would need to involve the following elements; one can call it a "grand bargain".

The first element is looking at the environmental footprint of trade and services, exported services from India, for example, versus exported goods from China. The environmental footprint of the exported services is about a tenth of the exported goods. Combined with the massive increase in digitalization of public services, of finance, the growth of remote work that we have seen with the Corona pandemic, it opens up the possibility for that new development model that I refer to earlier. It means that India may not need to follow the urbanization, every physical infrastructure investment, large scale manufacturing trajectory followed by China, but can instead do more place-based development where scarce capital is used to develop human capital over physical capital, where we do not make white elephants, such as ridiculously fast trains, or constructing concrete jungle cities. That would require the EU and the OECD to open up and to liberalize to trade in high-value added services that would allow for example Indian experts to be Goldman Sachs partners for European trades, to be working as researchers remotely, to teach, to be involved in policy decisions, in legal services and so on. At peak lockdown, two thirds of US and two thirds of EU GDP were delivered entirely remotely, working from home and services are 70% of GDP and rising. Clearly, that was not an equilibrium, but there is no reason why a third of GDP cannot be.

We are lucky because this came at the time of the biggest demographic asymmetry ever, where all the headlines in the EU and US are dominated by demographic decline, labor market shortages, while of the 25 million Indian and sub-Saharan Africans going to the workforce every single year, only 3 to 5% will be employed by the formal sector. This is a crime against macroeconomics, the neglect of that human capital potential that exist. There is a perfect way of bridging that. We have estimated that if this was done globally, the boost to global growth coming from this can potentially be twice as large as the golden age of globalization. Between the fall of the Berlin wall and China's entry into the WTO, a span of about 15-20 years, we saw the number of workers engaged in globally productive supply chain in goods doubled. We can do the same thing for a number of workers engaged in globally productive supply chains for services, which are the majority of our economy. We may deliver a huge boost of global growth allowing countries like India to grow, boost growth rates which are very low often near zero in the EU, tackle our demographic challenge, labor market shortages, and actually improve, bring the best brains in the world in the global workforce.

The second element would require technology transfer. We want that all the new steel and cement business models in India to be green and circular-economy based. The fact that matter is that the latest innovations and technological developments in green technology are mostly happening in the EU and the US, where the money and technological expertise and capacity are. However, what matters from the perspective of climate change is not if the next installation in Sweden is green steel or not, but that all of the steel deployed in a place like India in the next 20 years is green steel, that all the cement is green cement, the business is based on circular economy models. It is estimated that India will use more steel in the next 20-30 years than all of North America, South America and EU combined. Therefore, at the macro level for climate it really matters that it is done in a manner that is sustainable.

The third element is the mining and extraction problem. I am probably the only person in the macroeconomic policy space who actually worked in a mine. All mines are filthy, they are often corrupt, and they have high level of toxicity, environmental toxicity, loss of life expectancy. There is no clean mine but there are, relatively speaking, cleaner technologies. Combining these technologies with the use of escrow accounts, anti-corruption laws, anti-tax heavens laws and regulations, sovereign wealth funds-like structures to minimize Dutch Disease effects, we can sensibly deliver the material flows required often from some of the poorest, worst governed countries in the world, such as in many sub-Saharan African countries, some of them dictatorships. We can pursue this in a way that minimizes the toxic effects and the negative effects on life expectancy, and downstream value added possibilities, rather than trying to reach all clean mining and clean manufacturing in the EU, to capture more on this value added in many counties that are very, very poor.

The fourth element is the financeability. We are at the end of a period of super-normal financial returns, where Dutch, British, Nordic, American, and Japanese pension funds have managed to return 7 to 8 percent annually in economies that have only grown at 2 percent or so. This is arithmetically impossible over the long term and the laws of gravity have caught up. The drivers such as tax rate and interest rates were falling. Now those tailwinds have become headwinds so the future expected return by continuing to put 85 percent of EU and OECD pension money in other rich economies will only be 2 or 3 percent at which point our pension system will be completely unviable. The only way to make our pension system viable in the EU and the OECD

is to reallocate a significant amount of money away from inflating real estate prices in the Netherlands and the Nordics towards productive investments in economies that have the growth potential of 6 to 8 percent and a structural shortage of capital, such as India. Capitalism as it was supposed to be, were you deliver capital where there is a shortage of capital and that is where it generates the biggest profitability.

We calculated that this transition is financeable at the global level from our existing savings in a manner that it will also increase significantly the returns available to pension funds, making them viable while simultaneously reducing the risk, because India has much less correlation with countries across the Eurozone. It would help diversifying the risk.

Last but not least, the geopolitical dimension. Outside many small islands developing states, for some of whom it is probably too late, given how much climate change has already built in, there is something in this “grand bargain” which delivers growth, it is financeable, it delivers better financial returns and delivers welfare increases, poverty reduction and the SDGs, for each of the major group of countries, whether they are small low income countries, or whether they are dynamic larger emerging economies, or they are the EU, United States or Japan. That is the discussion we should be having.

**L.A.:**

Thank you Sony for this interview that allowed flying higher and not going necessarily in the nitty-gritty details of sustainable finance regulation.