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Research & Strategy Insights

Investing to pastures green(er)

60 – 21 September 2020

Key points

- The first "partial lockdowns" are coming to Europe. This will raise public deficits as the phasing out of emergency fiscal support schemes is delayed. The ECB seems ready to accommodate.
- We explore the green component of the EU's Next Generation plan. We think the focus on investment is the right way to combine support to economic growth and decarbonisation.

Some regions of Europe are returning to lockdown – for instance some districts of Madrid badly hit by the second wave of the pandemic. Yet, for now these lockdowns are very different from the ones imposed in March and April: schools remain open and commuting to work is still possible. This points to the entrenchment of a "90% economy": most sectors are allowed to operate normally and thus continue with their recovery, but some industries – e.g. hospitality – remain impaired for much longer than expected at the beginning of the summer. This is not necessarily consistent with a relapse in recession, but still creates policy challenges. Some of the extraordinary support measures set up last spring, which governments were planning to phase out this autumn, will probably have to be prolonged. France has already announced that its main part-time unemployment scheme which was going to be made less generous in October will remain available until next summer.

Government deficits will rise even further, and this in turn will force central banks to open the spigots of quantitative easing even wider. Last week we expressed the opinion that the hawkish noises in Christine Lagarde's latest press conference were not intentional. Statements from several ECB board members last week strengthened our view: the central bank's finger is on the buzzer. A report in the Financial Times on Sunday night indicated that a review of the Pandemic Emergency Purchasing Programme was starting, which could lead to the extension to the ECB's "ordinary" QE schemes of the flexibility already granted to the PEPP. We find this surprisingly early, but at least this makes our call for more ECB action in December more solid in our opinion.

A key feature of the fiscal stimulus plans in Europe is the centrality of green concerns. We think that reconciling economic growth and the green transition is better achieved when the policy instrument shifts to investment projects combined with carbon tax, rather than the usual combination of tax and production subsidy. Combining the EU's green agenda with concrete schemes to fund an investment surge – as per the "Next Generation" programme – is the right approach, in our view, to support both a decline in CO_2 emissions and the recovery from the pandemic shock.

In a New York state of mind

We have been intrigued last week by a twitter thread by Harvard epidemiologist Miguel Hernan, who explored the difference in the reaction to the pandemic in Madrid and New York. Both cities resorted to a very stringent lockdown when dealing with a particularly lethal pandemic wave. By June the "covid trajectory" of the two was very similar. A few months later, Madrid is facing a second wave and already engaging in "partial lockdown", while for now covid-19 has been kept in check in New York, which is planning a further relaxation of restrictive measures.

Hernan highlights two explanatory factors. First, New York ramped up its "contact tracers" capacity (a staff of 6,000) in the early summer, when the propagation of the virus had been brought back to a trickle, so that the small number of clusters could be quickly nipped in the bud. Given the difference in population Madrid should have hired 2,000 contact tracers to get to the same capacity as New York. It currently has just 700 and only 400 in the early summer. Second, New York kept its ban on in-door dining in restaurants throughout the summer (this will be relaxed with a 25% capacity cap on 30 September). By contrast, in Madrid in-door dining re-opened at 60% of capacity in June already.

If Professor Hernan is right, **a troubling consequence for economic activity is that the New York vs Madrid divergence points to "path dependence". In other words, choices made at one point in time constrain the choices down the road.** Copying today the New York approach in cities already facing a second wave would not be enough (e.g. contact tracing becomes logistically very difficult to organise once the number of clusters to investigate has exploded). New York cautious approach three months ago seems to pay now but stopping second waves where the same precautions have not been taken early could require more restrictive measures than what was implemented there. **In the UK for instance these considerations may contribute to the current debate on implementing a two week "circuit breaker" lockdown in October**, to bring back the propagation of the virus to a manageable level at which "smart" restrictive measures would work again.

Still, the notion of "lockdown" needs to be refined. For instance, in the Madrid districts where this is currently being implemented, schools remain open and people can still commute to work. Still, the "natural slope" in many developed economies at the moment is to opt for what The Economist labelled **the "90% economy" in early spring: some sectors – e.g. hospitality – would remain impaired for much longer than originally expected, while the rest of the economy would be allowed to operate almost normally**. Indeed, the experience of the last three months has seriously harmed the chances of allowing a normalisation of the whole economy. Footfall would remain "stuck" at sub-par level for a long while, as has been the experience of New York (Exhibit 1). The late spring US hotspots where mobility had to be curbed after the resurgence in the pandemic would be the blueprint for many developed economies (Exhibit 2). Many European countries (Spain, France, UK) which had waited longer than the US to re-open, hoping they would avoid a US style second wave, unfortunately failed to keep the pandemic in check now. Bringing the virus propagation to a minimum in June was not enough.

Exhibit 1 – The New York choice

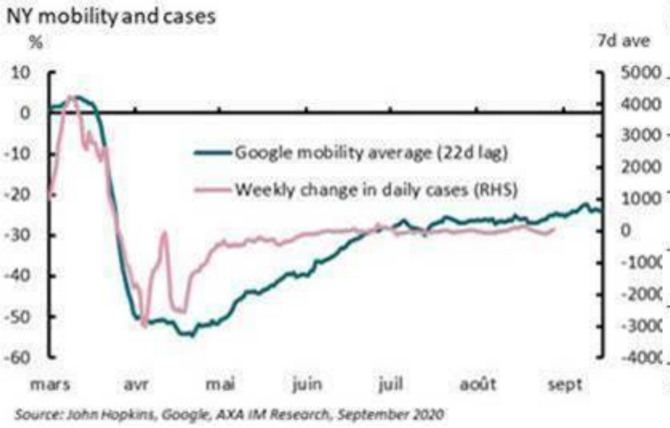
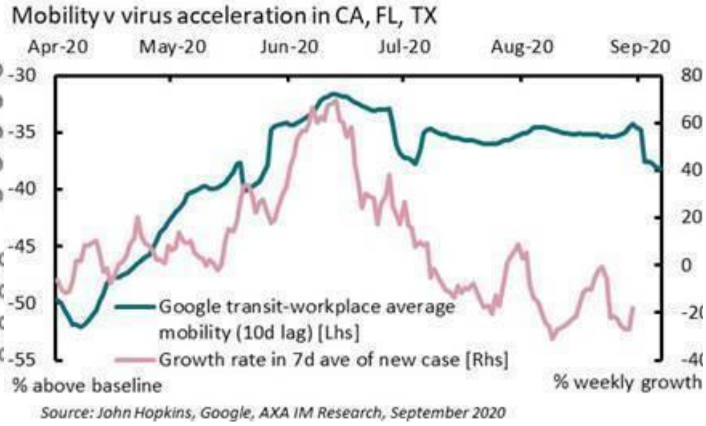


Exhibit 2 - Are US hotspots blueprints for European countries?



The "90% economy" is not necessarily consistent with a relapse into recession – the unimpaired sectors can continue their recovery while the industries that need to bear the brunt of the restrictions can stay merely flat – but still creates thorny policy challenges. Governments were planning to scale back the emergency support schemes put together during the spring as the supply-side disruption was expected to fade. With still significant sectors of the economy still stuck, we are starting to see some hesitation.

France has announced last week that the main scheme for part-time unemployment which was scheduled to be made less generous on 1st October will remain available until next summer while businesses negotiate with the unions "long term part-time unemployment" agreements. In the UK the Chancellor of the Exchequer is reportedly looking into alternatives to the furlough mechanism scheduled to disappear next month. Even Germany which so far has been resilient to the "second wave" was pro-active by announcing this summer already a prorogation of its own part-time unemployment scheme over the entirety of 2021. Of course, it would probably be more intellectually satisfactory to roll back the generic support scheme in favour of more targeted ones, but we suspect governments do not want to take chances: those "wide spectrum" measures will benefit the ailing industries without the need to create narrower systems which would run the risk of excluding some businesses (delineating the "90% economy" is not an exact science).

This suggests that the governments' funding needs will be even higher than expected. The European Central Bank (ECB)'s September forecasts have the general government deficit in the Euro area at 8.8% of GDP in 2020 (with public debt crossing the symbolic threshold of 100% of GDP) and 4.9% in 2021. Interestingly the ECB revised this forecast up from the June batch despite raising their projection up for GDP growth (which would normally mechanically reduce the deficit by boosting tax receipts). We think that despite taking on board a bigger stimulus, the ECB is still quite some way off the mark and that public deficit will exceed their updated projections.

ECB: (Not so fine) tuning

We expressed in Macrocast last week **our firm belief that the need to create comfortable funding conditions for governments is ultimately the key factor which will make the ECB announce a time and quantum extension of its Pandemic Emergency Purchase Programme (PEPP) at the end of the year.** We know the market was somewhat taken aback by some hawkish noises from Christine Lagarde at her last press conference, but we saw them as unintentional. Our view is strengthened by what we think was a concerted effort by other board members last week to provide a "dovish barrage", correcting the impact of the comments from the ECB President.

Philip Lane's key sentence in his now customary post press conference blog post was *"there is no room for complacency"* and his cautious discussion on inflation certainly did not echo Lagarde's point on "deflation risks abating". But we were also intrigued by another sentence towards the end of his post: *"over the coming months, a richer information set will become available that will help to inform the calibration of monetary policy".* This in our view was a way to confirm that for the Governing Council's preferred time for action is probably December. Isabelle Schnabel departed from her previous dismissive comments on the exchange rate issue and in an interview to Agence France Presse stated that "*We continue monitoring incoming information carefully, including developments in the exchange rate, and we stand ready to act if the incoming data is not consistent with the objective of our emergency measures to close the inflation gap that has emerged as a result of the pandemic".*

But it was probably de Guindos who was the most blunt in his comments, reflecting the importance of the "fiscal transmission channel" for the ECB at the moment and how they see their role, in an interview to La Razon. He stated that "*the first line of defence is fiscal policy, both national and pan-European"*, and later explained that the Pandemic Emergency Purchase Programme *"averted a sharp increase in spreads and enabled financial markets to remain calm. Thanks to that, we have avoided having to deal with a debt crisis on top of the public health and economic crisis, and this has been crucial".*

More action is on the way. But questions abound on *how* to deliver the next increase in bond buying. We discussed in July that the ECB could either expand PEPP or extend the flexibility of the PEPP to the "ordinary" quantitative easing programmes (in clear the "liberties" taken with the limits, the 33% of public debt and the capital key). From a technical point of view this would not change anything in the short run in terms of supply/demand conditions on the bond market but shifting to a more flexible Public Sector Purchase Programme which is potentially a permanent weapon in the ECB's arsenal would send a strong signal on the capacity of monetary policy for years ahead. The political implications are profound though, given the opposition of some key hawks to "permanent flexibility". An article in the Financial Times on Sunday night reports that discussions on this are already starting. We were surprised that it would come so early, but this is another sign that the ECB has its finger on the trigger.

Green transition: shifting from "tax & subsidy" to "tax & investment"

On the occasion of her speech on the "state of the Union", Ursula Van der Leyen announced an even more ambitious "decarbonization target", rising from 40% to 55% by 2030. This confirms the EU's refusal to sacrifice the fight against climate change in the struggle to re-start the economy. Quite the opposite. Public authorities – at least in Europe – have come to regard supporting the green transition as a way to spur economic growth, in contrast with a popular approach purporting an inconsistency between the two objectives.

There is a measure of political expediency in this choice. In many "core countries" of the EU where public opinion is traditionally hostile to fiscal activism, environmental concerns are high on the agenda. According to the last batch of the "Eurobarometer" survey, more than 30% of German respondents mentioned "climate change" among the top two challenges facing the EU, against 20% of the French and Spanish, and only 15% of Italians. This higher awareness of environmental issues in the North can be "leveraged" to elicit support for otherwise unpopular fiscal federalization projects. Still, beyond political expediency, we think that reconciling economic growth and the green transition is better achieved when the policy instrument shifts to investment projects combined with carbon tax, rather than the usual combination of tax and production subsidy. **Combining the EU's green agenda with concrete schemes to fund an investment surge – as per the "Next Generation" programme – is the right approach, in our view, to support both a decline in CO2 emissions and the recovery from the pandemic shock.**

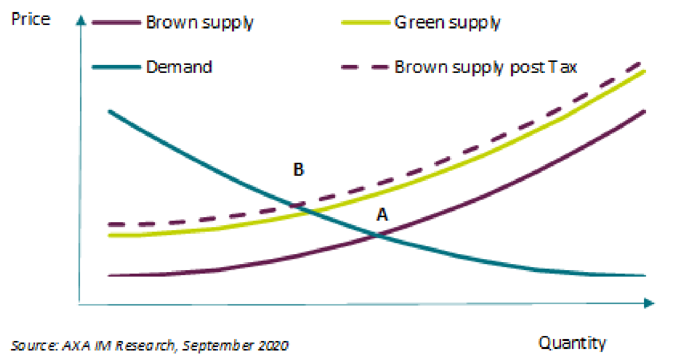
Let's start with some basics. The overwhelming consensus in the economic profession – one that your humble servant shares – is that taxation should be the main green policy tool. We have already explored in Macrocast the rationale of "Pigouvian taxes". The deterioration of the environment is an externality, a cost supported by all which is not paid by anyone through market mechanisms. Balance is restored by revealing this cost and charging those responsible for it (CO2 issuers). This can be done through several means, a direct tax on "brown energy" use for instance, or indirectly by imposing caps on total CO2 emissions allowing a trading system to emerge, and hence a market price for carbon as per the EU's Emissions Trading System (ETS) scheme. In any case, the idea is that public authorities punish "bad behaviour" while remaining agnostic on how economic agents will react. Every agent is free to find the best solutions to avoid the tax. Businesses can choose to change their production process, households can decide to change their energy supplier etc… but the government's "meddling" is kept to a minimum. It is a public policy by nudge.

An issue though is those Pigouvian taxes can be temporarily detrimental to purchasing power and hence economic growth. Producers can try to adapt to the higher cost of carbon by adopting less carbon intensive new technological solutions, but it is likely that those technologies will initially come with a higher price, in particular because they have to absorb the fixed cost of R&D expenditure. In extreme cases, the alternative technological solution may not be ready at all. Consumers are left with only unpalatable options: either paying more for the Green product – if it is available – or paying more for the taxed brown product. This is consistent with aggregate output declining – the meeting point between price and quantity shifts to the left, from A to B in Exhibit 2.

Of course, as demand shifts to the Green products, economies of scale kick in and their price can fall, gradually restoring aggregate output to its previous equilibrium, but the process can take time, and government – spurred by public opinion – may lose patience (even if it works to its advantage fiscally through collecting more tax). Engaging in active subsidization of the Green alternatives can be very tempting. The externality theory would favour supporting R&D expenditure, but very often "production subsidies", where the final price of the green product is made lower than its producer cost, are chosen. The effect of the subsidy is to "precipitate" the shift to the right of the green product's supply curve (from B to C in Exhibit 4).

Exhibit 3 - Either making “brown” more expensive…

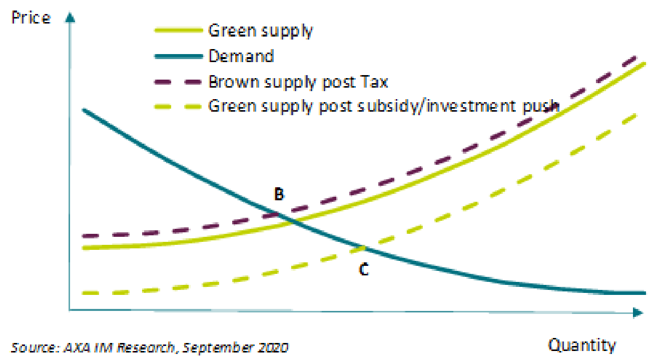
How Pigouvian taxes work



Source: AXA IM Research, September 2020

Exhibit 4 - …Or making “green” cheaper

How would subsidy/investment change things



Source: AXA IM Research, September 2020

Textbook economics are not keen on production subsidies, as they entail a much more direct impairment of market mechanisms than nudging through tax. The government is no longer agnostic but needs to choose which alternative solutions “deserve” to be supported, raising the usual questions as to the wisdom of public entities in allocating resources. But assuming the government makes the right choice, it would still be faced with an information asymmetry: a difficulty to get an independent appraisal of the producer cost. There is thus a possibility that the government – and hence society in general – pays “too much” for the transition.

The cost of the subsidy is hidden in the final price, but it does not vanish into thin air. A simple illustration of this is a “feed-in” approach in which producers of renewable energy get compensated for the difference between market electricity prices and their (higher) production cost, generating a surcharge for the final consumer. **The costs are not trivial. As Germany was pushing ahead on its energy transformation process, in the mid-2010s the surcharge to final consumers amounted to EUR20bn a year, 0.6% of GDP.** This cost amounts to a dent in aggregate purchasing power, which would shift the demand curve to the right in Exhibits 1 and 2. **We hit once more a sad but regular lesson of economic analysis: there is no such thing as a free lunch.**

The German economy is strong enough to shoulder this sort of cost, and at least the policy has been successful in bringing the cost of renewable electricity – which in 10 years was divided by 4 for solar power and fell by 30% for onshore wind –towards that of the conventional sources. The supply curve of the “green option” is following the path described in Exhibit 2, opening the door to phasing down the surcharge, but even in Germany cyclical conditions can get in the way. **As part of its fiscal stimulus plan to deal with the pandemic crisis the German government chose to cap the surcharge in 2021 and 2022.** Indeed, in a context of lower aggregate energy demand, wholesale electricity prices could fall, which would mechanically increase the cost of the price guarantee to the producers of renewable energy and thus the surcharge levied on consumers exactly at the time Berlin is trying to protect consume spending with a VAT cut.

In the meantime, the government will shoulder the cost of the guarantee so as not to jeopardize the producers’ programmes. Again, Germany can probably perfectly afford this, but we have seen examples in the recent past when the mechanics of the subsidies hit some fragile countries. The “electricity deficit” of Spain provides the best illustration. Through the recession of 2008-2009 and then the relapse due to the sovereign crisis in 2011-2012, the government chose to contain the rise in electricity production costs to the final consumers, creating a growing burden on public finances (3% of GDP at peak) at a time when the sovereign was facing very high refinancing costs amid generic market distrust in the sustainability of Spanish public finances . Supporting the renewable sector was only one of the factors generating this cost drift, but ultimately the Spanish government had to make the scheme less generous to renewables in 2013.

These examples illustrate why a focus on supporting direct investment in green solutions rather than subsidizing green production should be more efficient and create less conflicts between economic growth and decarbonization.

A major issue with production subsidy is that the government has no visibility on the time it will take for the price incentive to generate the private capital expenditure which will make the pre-subsidy cost of the green solution competitive. Actually, the logic can be inverted: it would be rational for investors to demand visibility from the government on a minimum duration of the subsidy before starting the projects. This means that governments lose capacity to adjust fiscal policy over a long horizon. **By focusing on investment – in practice by paying a share of the initial capex – governments regain control of their fiscal policy: the bulk of public sector expenditure happens at the *beginning* of the process, when capacity is built.** This approach would accelerate the emergence of green capacity, and in turn speed up the downward shift in the green supply curve.

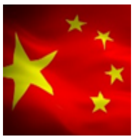
A 2017 academic paper, looking into 318 onshore wind projects in Spain concludes that the investment grant approach would have been more efficient than the production subsidy strategy which Spain followed in the 2000s, resulting in a cost to public finances of EUR0.8mn/MW against EUR1mn/MW in the feed-in tariff option. The authors note that although it would have been a cheaper option to focus on investment, governments are often put off by the need to be paid "up front", i.e. with an immediate impact on public finances. But equally, this reduces the risks of the green projects colliding with economic imperatives in the future.

This is where combining the EU's renewed ambition on decarbonization with the "Next Generation" programme provides a unique opportunity. The EU will issue EUR750bn of debt in the space of a few years – a third of the proceeds being directed to green projects – at a time when interest rates are extremely low. **This means that the acceleration in public green spending would occur at the least risky moment from a public debt sustainability point of view.** The risk of conflict between supporting the green transition and managing the cycle down the road is thus minimized. The fact that issuance is "federalized" limits the risk further by reducing the burden for the most fragile member states. The Next Generation programme is providing Europe with a rare "double dividend": boosting capex at a moment when the economy particularly needs it and accelerate the green transition.

Of course, on these matters the "devil is in the details", and a key question of course is whether the Next Generation Funds will get to support genuinely green projects. The system is indeed quite complex. The European Commission is not going to directly fund projects. National governments will present a "recovery and resilience plan" with a selection of projects to the Commission, ultimately for refinancing through the EU fund. In theory this could open the door to some leakage.

Yet, **Ursula van der Leyen also announced that 30% of the Next Generation debut issuance would take the form of a green bond. This creates a "double lock" on the benefit to decarbonization of the investment** plan. Indeed, Green bonds come with minimum traceability criteria which will make it difficult for national governments to engage in "greenwashing" when selecting projects for refinancing. Van der Leyen did not go into details, but we suppose the financing vehicle will be inspired by the proposal made by the EU's own Technical Expert Group 2019 report for an EU green bond standard, allowing supervision by third parties.

True, there is a debate on the impact of this financial instrument. A very recent research paper from the Bank for International Settlements which is currently "making the rounds" finds little evidence that issuers of Green bonds actually reduce their carbon footprint. Yet, we would insist on the fact that green bond issuance really took off in 2015 only and the authors have data on firm by firm carbon footprint until 2018 for the most part. Thus, we would question whether we should actually expect a visible impact in such a short time span. Greening production processes often take more time than the three years under review in the BIS paper. Some patience is needed. Vigilance will be needed of course, but in our view, Europe is giving itself a comprehensive framework to give a "green recovery" the best chances of success.

Country/Region	What we focused on last week	What we will focus on this week
	• The FOMC changed its forward guidance including labour-based contingencies. Fed does not expect to raise rates before 2024. • Retail sales came below expectations, while weekly readings of mortgage apps, economic activity and confidence all slipped. • President Trump supported latest House moderates' position for $1.5tn stimulus.	• Further signs of moving towards compromise on US stimulus package • Dynamic in weekly 'fast' data after unexpected softening • Preliminary durable goods orders for August, as Q3 GDP outlook looks more +ve • Election polling
	• ECB allows significant banks to temporarily exclude their holdings of banknotes, coins and central bank deposits from leverage ratio calculations until 27 June 2021 • EA IP growth was up 4.1%mom in July (after 9.5% in June) – still 7% below pre-Covid level • EC published guidelines for the Recovery and Resilience plans, focussing on 7 areas	• EA consumer confidence worth monitoring, on the back of rising number of Covid cases • Flash PMIs, but more importantly IFO and INSEE will help to gauge the strength of the recovery going into Q4 • Italian regional elections (Lega lead) and constitutional referendum (Yes lead) to have limited implications for the coalition
	• BoE left policy unchanged and highlighted uncertain outlook. However, reference to negative rates captured market attention. • CPI inflation in August fell back to +0.2%yoy – a five year low – on VAT cuts and EOHO. • Claimant jobless +74k Aug, +1.7mn since Mar • "limited progress" on trade deal seen as +ve.	• Further spread of coronavirus and resulting restrictions • Int Markets Bill sees second Parliamentary vote, trade negotiations in final few weeks. • Governor Bailey addresses Chambers of Commerce event • Consumer confidence for September
	• Y. Suga officially replaces S. Abe as PM • The BoJ remains on hold after its monetary policy meeting. • New Core CPI (exc. food and energy) turns back in negative territory (-0.1%yoy) • Both exports and imports increase, resp. to -14.8%yoy from -19.2% and -20.8% to -22.3%	• Flash September manufacturing PMI is quite uncertain as recent surveys point to a stabilisation in activity. Another month in contraction territory wouldn't be good news. • September CPI Tokyo usually leading nationwide level.
	• Better than expected August data shows the economic recovery has gained strength and balance	• Market liberalization will likely reach another milestone with RMB bonds included in FTSE Russell's WGBI
	• Last week, as expected, Taiwan's CBC and Bank Indonesia left their policy rates unchanged at respectively 1.125% and 4%. South Africa also surprisingly stayed put. Poland NBP expectedly stood on hold at 0.1%, as Brazil COPOM did, with rates unchanged at 2%. Russia on hold (4.25%).	• Central bank meetings: Hungary, Thailand, Czech Republic, Egypt, Turkey, Mexico, Colombia • Retail sales in Poland (Aug) • Industrial output in Taiwan, Ukraine (Aug) • Export orders in Taiwan (Aug)

Upcoming events		
	US:	Tue: Existing home sales; Wed: FHFA house price index, mfg, servs PMIs; Thur: Fed's Powell and Treasury's Mnuchin to testify before Senate on Covid relief; Fri: Durable goods orders
	Euro Area:	Tue: Ez cons conf; Wed: Ez, Fr, Ge mfg, servs PMIs, SP final GDP; Thur: Special European Council Meeting, Ge IfO business climate index, Fr mfg INSEE; Fri: M3 money supply, It ISTAT surveys
	UK:	Tue: Internal Market Bill vote, Governor Bailey addresses Chamber of Commerce, CBI Industrial Trends; Wed: mfg, servs PMIs; Thur: CBI distributive trades; Fri: GfK Consumer Confidence, PNSB
	Japan:	Wed: mfg, servs PMI, All industry activity index; Thu: BoJ minutes, BoJ core CPI
	China:	Mon: Loan prime rate (1-yr)

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