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# CIO Viewpoint

# Global carbon trading efforts multiply as EU price reaches record

Investment Solutions

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**The European Union is pressing ahead with plans to intensify carbon trading and China has launched its own emissions pricing mechanism. Accurately costing carbon and so creating an incentive to cut pollution, is key to meeting the Paris accord's climate goals. After months of intense fires and flooding in the northern hemisphere's summer, those global warming targets appear modest, given the challenges.**

Achieving 'net zero' carbon economies demands a complete reversal in our energy supplies. Fossil fuels currently supply around 80% of the world's energy needs, in line with a decade ago. We believe that accurately-costed carbon is necessary to encourage the transition to net-zero economies. Spurred by political and regulatory pressures, market forces including consumer and investor demand as well as new and cheaper technologies, are nudging change: solar energy, for example, is already less expensive than coal.

In July, the European Commission published new measures expanding its Emissions Trading System (ETS), designed to meet the European Union's 2030 target of halving carbon emissions. The proposals accelerate the speed at which the EU is withdrawing carbon allowances, cutting emission allowances by 4.2% per year, from 2.2% until now, and extending the number of EU polluters needing to buy them while phasing-out free allowances. Airlines, for example, currently only need to pay for one-sixth of their emissions.

The ETS has imposed pollution ceilings since 2005. In 2018, the price of carbon under this cap-and-trade system breached EUR 10 per metric tonne for the first time. EU carbon prices have risen almost 90% year-to-date, from EUR 33 per tonne to a record EUR 62 last week. Over the same period, the price of a barrel of Brent crude oil has gained 36% from USD 52 to USD 71/barrel, as demand recovered along with economies' re-openings.

The World Bank has estimated that the price needs to be closer to EUR 100 per tonne this decade, in order to meet the Paris Agreement's more demanding goal of limiting global warming to 1.5 degrees Celsius.

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### Key takeaways

- European carbon prices have almost doubled this year to a record EUR 62 per tonne
- The EU's carbon trading system is accelerating emissions cuts and the bloc plans an import tax
- In July, China began its own emissions trading mechanism for 2,200 coal and gas producers
- Carbon prices need to reflect the true cost of emissions in order to encourage the transition to net-zero economies.

## Border cheques

The European Commission's plans also include a system to impose a 'carbon border adjustment mechanism' on imports from countries that do not price carbon. This is designed to avoid pushing carbon-intensive production 'offshore,' and explicitly encourage other countries to cost emissions more accurately. It also cushions European industries from concerns that they are unilaterally penalised compared with competitors elsewhere.

Some countries' carbon taxes arguably set a price floor. Globally, Sweden and Switzerland impose the highest carbon taxes, at EUR 117 and EUR 101 per tonne, respectively, at current exchange rates. Switzerland's carbon tax will rise to CHF 120 (EUR 110) per tonne in 2022, after the country missed a target to cut emissions in 2020.

Not everyone believes that import taxes are part of the answer. John Kerry, the Biden administration's Special Envoy for Climate Change, said in March 2021 that import tariffs carry "serious implications for economies, and for relationships, and trade" and so should be "more of a last resort" when a broader common solution has failed.

China's President, Xi Jinping would appear to agree, describing carbon taxes as trade barriers. Last week, Mr Kerry met with Chinese officials to ask the country to follow the US, EU and Japan in ending support to foreign coal-powered energy projects.

## Trading spreads

An estimated 45 countries have some form of carbon emissions trading system. China, the world's biggest carbon polluter, became the latest country to begin trading the right to emit carbon on 16 July. Attempts to limit global warming depend in part on China's contribution to cutting emissions as the country accounted for around 27% of global greenhouse gas emissions in 2019.

The world's second-largest economy has run pilot emissions trading projects since 2013, and its system now takes account of carbon as a share of energy produced, rather than absolute emissions. That should incentivise polluters to improve their efficiency, as the Chinese authorities cut the amount of allowances available over time. For now, China's system only applies to around 2,200 coal and gas energy producers, but is expected to extend to construction, chemicals and the oil industry by 2025.

China is committed to a carbon-neutral economy by 2060. So far, ETS volumes have been slow and the price has fallen as low as RMB 45 (EUR 5.9) per tonne, compared with RMB 51 on the first day of trading.

## Floors and stresses

In June, the International Monetary Fund outlined a proposal that would set minimum carbon prices globally by 2030, ranging from USD 75 to 25 per tonne, depending whether an economy is classified as 'advanced,' 'high' or 'low-income.' That would help to keep emissions this decade below the 2 degrees Celsius Paris accord target.

Other institutions are also applying pressure for change. Bloomberg reported last week that the European Central Bank has called on commercial banks to prepare themselves for stress tests next year. These would need to set out lenders' balance sheets' sensitivity to climate change risks as far as 2050. Commercial banks have a role to play in the transition to a net-zero economy by re-directing capital away from polluting industries.

Recent extreme weather events should help to focus political minds on the need for action. In the light of historic heat and wildfires in the US and southern Europe, as well as record rainfall in China and flooding in central Europe, world leaders will have a chance to review their governments' commitments ahead of the United Nations' Climate Change Conference ('COP26') from 31 October to 12 November. The Paris agreement on climate change pledges to keep global warming to "well below" 2 degrees Celsius above pre-industrial levels, and make "efforts" to limit warming to 1.5 degrees. Six years later, that goal looks much more urgent, and the measures to reach it do not seem ambitious enough.

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