EDITORIAL

WILL THE ENERGY TRANSITION CAUSE AN INCREASE IN INTEREST RATES?

Meeting the European Union's climate-related and digital ambitions will require a huge additional annual investment effort. In the near term, against a background of slowing growth and the prospect of a recession in 2023, this represents a potential source of resilience. In the medium term, this demand impulse may underpin or even increase inflation, in addition to other factors that could lead to greenflation. This would influence the level of official interest rates as well as long-term interest rates. The latter could also be under upward pressure due to the huge additional financing needs compared to the normal financing flows. The financing mix -banks versus capital markets- plays a key role in this respect.

According to the European Commission, meeting the European Union's climate-related and digital ambitions will require an additional annual investment effort until 2030 of EUR 650 billion.[1] Compared to GDP and the normal level of investments, the numbers are huge. In 2021, this sum would have represented 4.5% of GDP.[2] For the period 2000-2021, gross fixed capital formation of households, companies and the public sector represented on average 21.5% of EU GDP, so the additional investments would represent an increase of gross investment of more than 20%. Macroeconomically, the green transition can be considered as the accelerated replacement of old, high carbon-footprint technology with new environmentally friendly technology.[3] Likewise, the digital transition represents an accelerated investment effort, with, amongst others, a key objective of remaining competitive.

Clearly, one should assume that, to some degree, there will be a substitution effect -outdated capital stock would have been replaced anyhow- so the net effect is virtually impossible to determine. However, by simply looking at the investment needs for the production and distribution of alternative energy as well as those for making houses and buildings in general more energy efficient, one should assume a significant increase in capital formation and demand in general over the coming years.

Against a background of slowing growth and the prospect of a recession in 2023, this represents a source of resilience. Companies operating in the sectors that will benefit from the demand for capital goods will look at the future with greater confidence than would otherwise have been the case. This in turn will influence their business strategy, hiring plans, etc., thereby creating positive spillovers effects to other sectors.

This demand impulse may underpin or even increase inflation, in addition to other factors that could lead to greenflation.[4] Under such a scenario, this would influence the level of official interest rates as well as long-term interest rates. The latter could also be under upward pressure due to the huge financing needs. The chart shows the financing that has been available to the resident private sector in the euro area annually since the end of the nineties by means of bank

EUROZONE: NET FINANCING FLOWS TO THE RESIDENT PRIVATE SECTOR

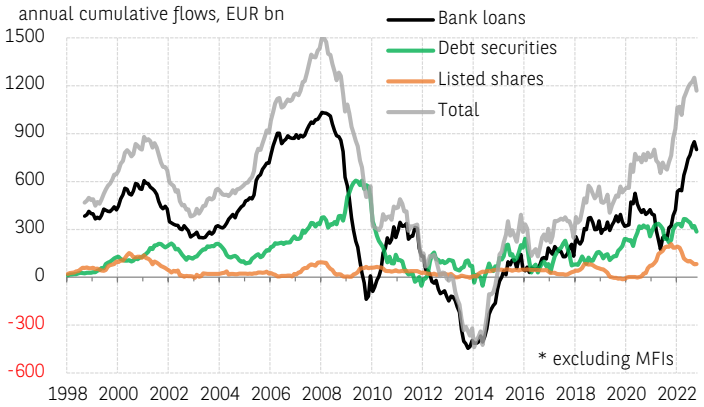

CHART 1 SOURCE: ECB, BNP PARIBAS

1. Source : ECB, Financial Integration and Structure in the Euro Area, April 2022.
2. In 2021 EU GDP amounted to EUR 14.5 trillion (source: Eurostat).
3. 'Technology' has a very broad meaning in this context, in order to simplify things. It covers the size of the capital stock as well as its quality -from a technological and environmental perspective-, the capital stock to produce and distribute alternative energy, the environmental characteristics of buildings, etc.
4. The other factors concern the price of energy: "The combination of insufficient production capacity of renewable energies in the short run, subdued investments in fossil fuels and rising carbon prices means that we risk facing a possibly protracted transition period during which the energy bill will be rising." (Source: Looking through higher energy prices? Monetary policy and the green transition, Remarks by Isabel Schnabel, Member of the Executive Board of the ECB, at a panel on "Climate and the Financial System" at the American Finance Association 2022 Virtual Annual Meeting, 8 January 2022).

The additional annual investment effort to meet the European Union's climate-related and digital ambitions will, given its size compared to normal financing flows, probably put upward pressure on interest rates. The financing mix -commercial banks versus capital markets- will play a key role in this respect.

lending, debt issuance and raising equity capital. It allows to compare the additional investment need -the call on financing- with what has been available in the past. Assuming that in the euro area the additional investment efforts as a percentage of GDP are the same as in the EU, it would imply an annual amount of EUR 550 bn. Compared to the financing flows of 2008, which was a record year, this would represent 37% of the financing available that year. For any other year, the numbers would be even more impressive. This raises the question on the possible impact on interest rates. In national accounting, the available means of financing correspond to the needs, an identity which is commonly referred to as 'savings equals investments'.[5]

However, the reality is more complex: the fact that savings equal investments is the result of a dynamic process whereby interest rates play a key role in arriving at a balance between the two. Given the size of the additional annual investment effort and what it represents as a percentage of financing flows, it is to be expected that it will lead to upward pressure on real interest rates, in addition to the role played by greenflation on inflation expectations of financial market participants. The financing mix plays a key role in this respect. To the extent that it is predominantly bank-based, the money creation of commercial banks should limit the upward pressure on real interest rates. When financing comes from capital markets, there is no money creation, so higher interest rates will be necessary to entice an increase in savings and possibly attract capital inflows to meet the financing needs.

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5. Households typically save more than they invest. Their net savings surplus can finance the net borrowing requirement of the public sector, of companies or of foreign sectors. The current account surplus of a country corresponds to a net savings surplus of the domestic economic sectors (households, companies, public sector), which enables them to finance foreign sectors. A current account deficit corresponds to a net savings shortfall of the domestic economic sectors, which forces them to rely on foreign sectors to cover this deficit.