EDITORIAL

GREEN INVESTMENTS, PUBLIC DEBT AND FINANCIAL MARKETS

Limiting global warming will require huge investments, which will partly have to come from the public sector. This could lead to a crowding-out effect. Higher public borrowing requirements could push up interest rates and weigh on private investments. In the near-term such a risk seems remote. On the contrary, there could be a crowding-in effect with a reduction in climate-related risk and positive second-round effects from green public investments stimulating private investments. To reduce the risk that financial markets would exclusively focus on the impact on public indebtedness, governments should communicate clearly on the nature of their investments, insisting that they should have a return which is a multiple of the borrowing cost.

Limiting global warming and, more broadly, making production and spending more environmentally sustainable will require huge investments.

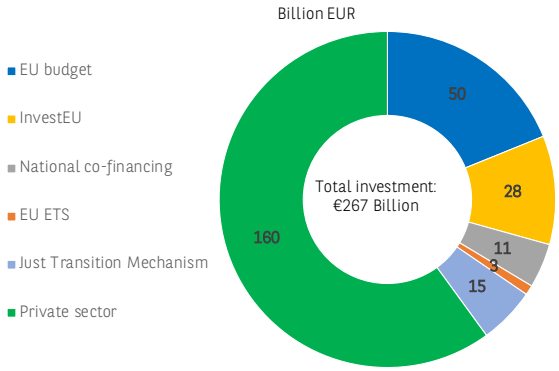
The European Commission considers that for the EU to reach the climate and energy targets by 2030, it will require additional investments of EUR 260 billion a year over the coming decade[1], or 1.5% of GDP (in 2018 prices). The effort will have to come both from the private sector (EUR 160 billion) – businesses as well as households – and the public sector (EUR 100 billion) (see Chart). For the latter, this means more pressure on government finances, which raises the question whether a massive green public investment programme might cause a crowding-out effect.

Higher borrowing requirements could exert upward pressure on interest rates[2] thereby weighing on private sector investments. In the near-term such a risk seems remote. GDP growth should accelerate in the second half of the year and boost the willingness of companies to invest. This should outweigh the headwind coming from somewhat higher interest rates. In addition, ongoing ECB asset purchases would also limit the likelihood of a significant increase in bond yields. There is actually a lot of merit in the counterargument that higher public investments in climate change and energy transition could trigger a crowding-in effect, whereby private investments are stimulated[3]. This could result from a reduction in climate-related risk – which makes companies more confident when doing long-horizon planning – or, importantly, from positive second-round effects from green public investments. They enable companies to step up their R&D spending, which is instrumental in becoming more innovative and competitive. This in turn would stimulate employment, corporate investment and hence GDP growth. This corresponds to the philosophy underpinning Next Generation EU.

Still, the question remains whether, in the medium-run, a backlash could occur. In many countries, public finances have seen a huge deterioration following the outbreak of the Covid-19 pandemic. The structural reduction of public deficits will need to be a gradual process, in order not to nip the recovery in the bud. When adding to this the necessity of important green investments, there is even a risk that public sector indebtedness would continue to increase. Eventually, this could lead to a repricing of sovereign risk and hence higher bond yields.

Such a possibility should not stop governments from making the necessary investments. Not doing enough collectively would imply a certainty of negative economic consequences further down the road. In debt sustainability terminology[4], *g* would decline and this could actually increase *r* via a sovereign risk premium effect.

EU GREEN DEAL: SOURCES OF FUNDING



InvestEU: InvestEU Programme combines the European Fund for Strategic Investments (the Juncker Plan) and 13 other EU financial instruments.

EU ETS: EU Emission Trading System

SOURCE: EUROPEAN COMMISSION, BNP PARIBAS

1. European Commission, Sustainable Europe Investment Plan -European Green Deal Investment Plan, Brussels, 14.1.2020, COM(2020) 21 final. This was before the EU decided to cut carbon emission back by 55% by 2030 from an earlier agreed 40% objective.
2. The rationale is that the higher public investments require an incentive under the form of higher interest rates to step up savings in order to provide for the financing.
3. For an analysis of crowding-out versus crowding-in, see *Macroeconomic rates of return of public and private investment. Crowding-in and crowding-out effects*, ECB working paper 864, 2008.
4. Public debt sustainability is traditionally analysed in terms of primary balance (the budget deficit excluding interest charges), *g* (the expected long-run growth of nominal GDP) and *r* (the average nominal interest rate).

> To avoid that financial markets would exclusively focus on the impact on public indebtedness, governments should communicate clearly on the nature of their investments, insisting that they should have a return which is a multiple of the borrowing cost.

Making the necessary investments would protect *g* and it remains to be seen to what extent this would cause an increase in borrowing costs. To reduce this likelihood, the issuance of green bonds – which typically carry a lower yield compared to conventional bonds – would clearly help. What would also help is clear communication to the market about how the proceeds of the bond issuance will be used. Public green investments should have a return on investment which is a multiple of the borrowing cost, all the more so when taking the second-round effects into account, so for the society as a whole they will be value-enhancing, something that bond investors should be sensitive to.

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