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Robeco Summer Sessions

Session 4:

Addressing Climate Change & Opportunities for investors

Lord Nicholas Stern, IG Patel Professor of Economics and Government at the London School of Economics, interviewed by Brendan Maton, financial journalist

Addressing Climate Change & Opportunities for investors

Lord Stern, welcome. I would like to ask you: How serious is the challenge that climate change presents to the world?

We're the first generation which has the opportunity, if you want to call it that, through our neglect, to dramatically change the way in which human beings live and where they can live, from the point of view of the planet as a whole. Let me just illustrate this with one simple calculation. If we go on with business as usual, some time at the end of this century, early next century, we would have raised the temperature of the planet (with probability at least half) by five degrees centigrade relative to the 19th century. That is enormous. The world as a whole, the planet, has not been there for 30 million years, at that temperature. Humans have been around for a 100,000. Sea-level rise would be very big, the pattern of rivers would change, some parts of Southern Europe would be a desert like the Sahara desert, some parts of the United States would just dry out, others hit by hurricanes, the main rivers of Asia flowing off the Himalayas would be dramatically affected, all the things that affect where we are, and why we are where we are; population movements would be hundreds of millions of people, probably billions of people and there would be extended conflict. Those are the kinds of stakes that we are playing for. But there's good news in that, if we act sensibly, we can dramatically reduce those risks and in so doing, we can put ourselves on an alternative low-carbon growth path, which is actually rather attractive.

Can you give some ways in which institutional investors can act sensibly, earn a return and help stop climate change becoming a big problem?

If you are a long-term institutional investor, you can ask yourself the question: where are technological opportunities going to be; where are the big demands for investment going to be, and what's going to happen to government policies and incentive structures? And, of course, what will our workers and customers in firms, and the people who buy those investments, invest in our funds, what will they want? Now if you look at that, you have to recognize that the big drivers of growth over these next two, three, four decades are going to be low-carbon technologies and energy-efficient technologies. You have to recognize that that's where government policy will go. We hope faster than it's gone, but it will go in that direction. You have to look at what consumers are demanding: they're demanding responsibilities of firms; firms that are seen to be irresponsible will be in difficulty. So from those points of view, if the institutional investor anticipates well where things are going – and I've tried to describe why we should anticipate that they will go in that direction – such an institutional investor should be able to identify early real-growth opportunities. And an institutional investor will recognize those things which might be stranded and dislocated if they do not embrace the new technologies and the new opportunities. So there, I think, we have a very clear indication: from the point of view of returns and from the point of view of risks, institutional investors really do need to analyze these issues carefully. And I am optimistic that increasingly that's exactly what they are doing.

Can we talk about carbon trading and what opportunities lie there for investors?

The carbon markets at the moment are driven largely by the European Union emissions-trading scheme and, within that, in the context of the Kyoto protocol, there's a thing called the clean-development mechanism, where you can buy reductions in a developing country, and then of course you have to have a complex procedure for deciding what a reduction is, and identifying it and certifying it. That's the way the markets are at the moment: the EUETS (European Union Emission Trading Scheme) is quite a big market, it covers 40% of Europe's emissions, but of course Europe is only 15% of world emissions. And the clean-development mechanism is quite small. So where is it going to go from here? The United States will probably (sometime between 2010 - 2011) start an emissions-trading scheme. That's a big addition to trading and it's important that it links up with Europe. In the context of a Copenhagen agreement, which we hope will come at the end of 2009, we could see a big expansion in the possibilities in the clean-development mechanism. So it's those two things, the United States market and the way in which the clean-development mechanism is reformed, which will influence just how big those markets are.

Trees are vital for the world, they are vital for the eco system. Can you tell us whether forestry represents in any way an investment opportunity?

It should, and it will depend on policy. But the first thing is to recognize just how big deforestation is in this question. It's up to... and it is very difficult to get the numbers precise, but it's 15 or 20% of global emissions. That's bigger than air and ground and sea transportation put together. It's a very big issue, particularly in the loss of tropical forests, and that is concentrated in a few parts of the world: Brazil, Indonesia, Malaysia and the Congo would be the bulk of that story. So we all have a very strong interest in stopping deforestation. And one way, an important way of doing that, would be to attach carbon values to the trees themselves. They have great value as standing trees to us all, and we have to try to create markets where that value is rewarded in the marketplace. Some private investors, through voluntary offset schemes, are already doing that. It's the intention to build carbon markets and deforestation together in Copenhagen. That was agreed in the United Nations Framework Convention on Climate Change meeting in Bali at the end of 2007. So it's on the program for Copenhagen, and it's very important that it goes forward. But you can't stop deforestation just through carbon markets. It involves creating other things for people to do who might otherwise try to cut down the forests. It means making agriculture more productive; it means creating opportunities outside agriculture. It means much better observation and monitoring systems. It means legal structures that work. In other words, it means promoting development in the relevant countries and supporting development in the developing countries.

Do you think that climate change could halt or even reverse the process of globalization?

I don't think so; I actually think it will be the contrary. In order to tackle climate change effectively, we have to collaborate on a scale that we have not yet really seen as a world. That means creating the carbon markets; it means creating mechanisms to regulate the carbon markets. It means sharing technologies.
In other words, if we think hard about what's necessary to handle climate change, we will recognize that it will require collaboration and mutual understanding and international institutions and relationships to deepen. We will find that the collaboration that has been created on climate change will actually enhance those other collaborations; so we would learn how to do something that's difficult.

What are your hopes and fears for Copenhagen?

We now have got ourselves into a position with the movements and political understanding and commitments and recognition of the problem of climate change over the last three or four years; we have now got to a position where we really have a chance of an agreement. We have created an opportunity which we could lose, and we've created an opportunity which we could turn into reality. So we now have a good chance. It's difficult to put percentages on it, because this will be a discussion where some things are strong, some things are weak, some things are negotiated too weak, and we have to see what happens. But I think the big targets on reductions for the world of 50% of emissions reducing between 1990 and 2050 will be achieved, and I think the rich countries will take on 80% reduction targets in terms of their emissions 1990 - 2050. It's going to be difficult to get the agreement on the next 10 or 15 years. And that would be very important; and developing countries will look for credibility from the rich countries. Developing countries will look for finance, and substantial finance, and they'll look for an increase in carbon trading. And rich countries will look for actions in developing countries which indicate that they are taking it seriously, and that their emissions will peak fairly soon; in the case of China within 10 years, and in the case of, say, India within 15 or 20. So the big headline numbers we have a good chance of agreeing on; on the interim figures for 20 to 25, I think we can get agreement, but it is going to be tough. On finance, there will be a lot of haggling about how much finance and how it's generated, but I'm hopeful we'll get to some conclusions. It can go wrong in terms of mid-term targets for rich countries; it can go wrong in terms of finance; and it can go wrong in terms of excessive aggression from the rich countries on exactly what the developing countries are committing to. A lot of people, including myself, will be working hard up to Copenhagen in December this year to make it happen. We won't fill in all the details, but we have to get the key framework right.

Lord Nicholas Stern

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From 2005-2007 he was adviser to the UK Government on the Economics of Climate Change and Development, reporting to the Prime Minister and the Chancellor of the Exchequer and Head of the Stern Review on the Economics of Climate Change. He was also Head of the Government Economic Service, 2003-2007; Second Permanent Secretary to Her Majesty's Treasury, 2003-2005; and, Director of Policy and Research for the Prime Minister's Commission for Africa, 2004-2005. From 2000-2003, World Bank Chief Economist and Senior Vice President, Development Economics. From 1994 until late 1999, Chief Economist and Special Counsellor to the President European Bank for Reconstruction and Development.

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