Chi on China

FOR WHOLESALE INVESTORS – 25 July 2018

MEGA TRENDS OF CHINA (3C): THE BELT AND ROAD STRATEGIC PLAN – THE “GREEN” BRI OPPORTUNITIES AND CHALLENGES

Our population and our use of the finite resources of planet Earth are growing exponentially, along with our technical ability to change the environment for good or ill.

Stephen Hawking

SUMMARY

- As China implements its Belt and Road Initiative (BRI) earnestly and at the same time pledges to promote green environment and sustainable growth, questions abound on its commitment to achieving both objectives simultaneously.
- How does the BRI relate to the global environmental, social and governance (ESG) initiatives? Is there any evidence for China putting its green incentive into practice while implementing its BRI? What are the challenges that China will face by going green?
- Will China stick to its green promise? What are the forces that will help shape the future of green finance and where does China stand in green financing? What are the opportunities and challenges that China's actions may present to the world?

As China ascents to the world stage with growing economic influence through its Belt and Road Initiative (BRI), it also wants to showcase its “green” leadership. The incentives to do so should be strong because as the world’s largest greenhouse gas-emitting nation, China’s growth is unsustainable and has negative externalities on the world economy.

BRI TO EMBRACE SUSTAINABLE DEVELOPMENT BUT…

In principle, China is trying to embrace in its BRI infrastructure projects five of the 17 areas of the United Nations’ Sustainable Development Goals (SDGs), which were adopted in 2015:

SDG #6: Clean water and sanitation – ensure access to water and sanitation for all people.
SDG #7: Affordable and clean energy – ensure access to affordable, reliable, sustainable and modern energy for all people.
SDG #11: Sustainable cities and communities – make cities and human settlements safe, inclusive, resilient and sustainable.
SDG #13: Climate action – combat climate change and its impact urgently.
SDG #17: Partnership for the goals – strengthen the means of implementation and revitalise the global partnership for sustainable development.

However, one of the largest Chinese investment categories in the developing countries is coal-fired power plants. The Global Environment Institute found that between 2001 and 2016, China developed 240 coal-fired power projects in 68 countries, most of which are associated with the BRI since its inception in 2013, for a total of 251 GW of generating capacity or about 25% of China’s domestic coal-fired capacity. This shows that China has yet to deliver its green pledge in the BRI investment.

Hitherto, Beijing has yet to establish the principles to guide environmentally sound investment abroad. Its export of dirty-energy technology undercuts the credits it gets for going green in its domestic energy initiatives. It will have to embrace responsible investment rules to fend off international criticism on its lack of sustainable growth and investment strategies.

DOMESTIC EFFORTS ARE STRONGER

However, China has made progress towards some of the SDGs in the domestic system. Environmental policy and enforcement have become more systematic since President Xi came to power in 2013 when the State Council approved a comprehensive action plan to reduce air pollution. This was followed by plans to reduce water and soil pollution in 2015 and 2016, respectively. These plans established local and national targets and time-lines for pollution reduction, taking aim at the highly-polluting sectors. If fully implemented, the plans would amount to the world’s largest ever environmental clean-up effort.

China has also stepped up the pace of environmental innovation, with initiatives in carbon pricing, clean-energy finance and electric vehicles. In June 2017, it rolled out a pilot programme for green finance in five provinces to promote a USD440 billion spending scheme on environmental protection projects. Then in November, it launched the long-awaited carbon emissions trading scheme, which could become the world’s largest carbon market.

China is now the world’s biggest investor in renewable energy technologies. In 2016, it accounted for almost 50% of the world’s installation of new wind-power capacity. By 2020, China is expected to account for more than a third of the world’s total wind-power capacity. It has also vowed to achieve the international goal of limiting global average temperature increase to less than 2^{o}C through the Paris Agreement.

INCENTIVES AND FORCES TO GO GREEN

The macroeconomic incentive for going green is consistent with Beijing’s economic rebalancing objective of less investment, less industries and more consumption, more services. China has been the biggest contributor to the world’s greenhouse gas emissions that cause climate change because of its rapid industrialisation powered by coal-fired power plants.

So it has to change its economic development model in order to deliver President Xi’s green pledge. His “new normal” policy, by focusing on slower growth but higher efficiency via structural reforms and the development of low-energy-intensity technology sectors, will be instrumental in facilitating the energy and economic transition. The shift to renewables, for example, is motivated by an expected 13-million job creation in the renewable energy and environmental technology sectors by 2020.

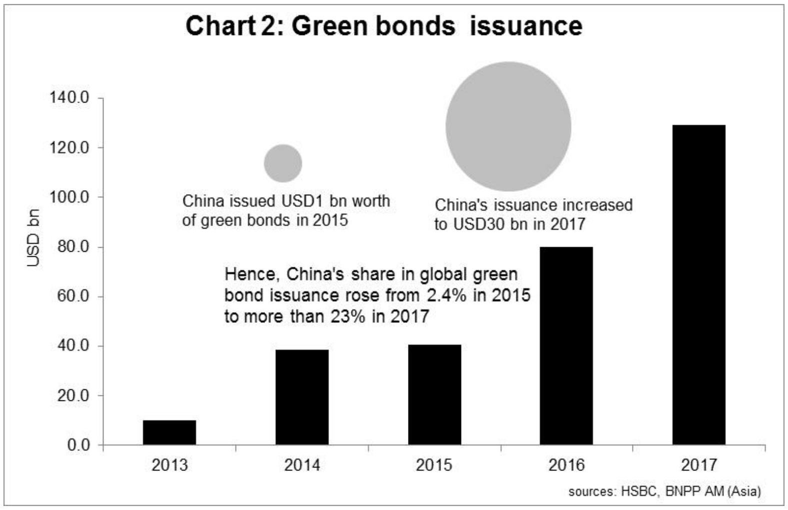
Under the old growth model, high-carbon investments were seen as lower-risk and higher-reward than low-carbon investments as the economy was dominated by the secondary sector. But this has started to change since 2013 when China’s tertiary sector (a proxy to the new and greener economy) has grown bigger than the secondary sector (Chart 1). As low-carbon technologies grow more mature, the risk-reward profiles of high-carbon versus low-carbon investments will invert.

Many financial institutions are staring to shun high-carbon activities in favour of low-carbon activities, with some fund managers trying to ‘decarbonise” their portfolios. Government regulations are acting to reduce the returns on high-carbon economic activities by increasing the cost of greenhouse gas emissions. Furthermore, changing consumption pattern towards more green goods and services, such as solar energy, wind power, electric vehicles and personal services, is also forcing a shift in production behaviour towards sustainable growth.

GREEN FINANCE

Chinese banks have started to issue BRI-related green bonds. These bonds are standard fixed-income instruments with the usage of proceeds designated for green projects. The Industrial and Commercial Bank of China issued its first One-Belt-One–Road Climate Bonds in Luxemburg in September 2017, raising more than USD2 billion for financing and re-financing projects in low-carbon and low-emission transport, renewable energy, energy efficiency and water resources management. At the same time, China also hosted an international Green Finance Forum in Beijing for discussion on green finance tools and products, environmental risk analysis and the ways to enhance the green preference of investors investing in the BRI countries.

China’s green bond market is among the largest in the world, with its share in global green bond issuance rising from only 2.4% of the world total in 2015 to more than 23% in 2017, according to some estimates (Chart 2). Other green financing tools and investment instruments are being developed, including green loans, green securities, green insurance, green banks and green funds. They share the common characteristics of 1) providing lower financing cost to green projects than to conventional investments and 2) all proceeds will go to finance green projects only.



THE ULTIMATE QUESTION

The billion-dollar question is what will ensure China puts its green incentive into practice, including in the BRI investments? There is no guarantee of course, but President Xi’s track record of making changes in the priority areas that he identifies may give some level of confidence that China’s will act upon its green promises.

As I argued recently[1], what is revolutionary about Mr. Xi’s approach is his forceful change of the political and economic incentives that had governed the country for over three decades. He has changed the incentive scheme of the system from single-mindedly maximising growth, which was responsible for creating a highly-polluting growth model, to multi-targeting different policy goals, including sustaining GDP growth, alleviating poverty, reducing financial risk and protecting the environment.

Note that environmental protection is one of those new targets. The point is that by replacing the old incentive, which was easy to pursue, with a complex set of priorities, which makes optimising all the policy goals simultaneously impossible, Mr. Xi is creating a political environment to ensure compliance by local officials. Since the local officials do not know the target weights in Beijing’s multiple goals, they are more likely to just do what they are told rather than be defiant as in the old incentive scheme.

THE ULTIMATE CHALLENGE

The biggest challenge is always about implementation, which is all about governance, transparency and disclosure. China will have to build the regulatory framework to ensure the environmental integrity is upheld.

With President Xi re-centralising a lot controls[2], his administration should be able to mobilise a lot of investment in new and environmental-friendly technologies. But there is also a question about his willingness to assume the burden of global leadership that the green practices would entail. In climate negotiations, China has repeatedly

[1] See “*Chi on China: Mega Trends of China (6): Evolution of China’s Growth Model*”, 6 April 2018.
[2] See reference in footnote 1.

argued that developed nations should bear the brunt of responsibility for climate change, citing those countries’ historic emissions and a right to development for emerging economies.

In a nutshell, the incentive for China to go green, including in its BRI investments, should be strong, but the challenges to deliver especially the “G” part of the ESG initiatives are also big. Given Beijing’s green initiatives so far, the Chinese market has big potential for the future of green finance and investment.

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