Going for the green diagonal

87 – 19 April 2021

Key points

- We look at an understated aspect of the US administration's "green conversion", the role of the federal regulatory agencies, in the context of the US attempt to assert global leadership in the fight against climate change.

The US administration's green investment plan is spectacular and understandably grabs global attention, but we think a more discrete thread of US activism in the fight against climate change deserves some attention: federal regulatory agencies are stepping up their efforts in embracing green issues. The legal ramifications of their approach are often complex, but it can be an effective accelerator of the ecological transition in the US.

The EPA is reconsidering a petition to include CO2 emissions in the scope of the National Ambient Air Quality Standards framework, which would force all 50 states to design a carbon strategy, with penalties in case of non-attainment, without the need of congressional action. In practice, it could be a cumbersome approach and may not be the simplest way to advance the fight against climate change in the US, but it may convince moderate Democratic and Republican Senators to reach a compromise with the White House on the green investment plan. At the same time, the SEC is stepping up its efforts in the field of green finance regulation, an area in which the US has traditionally been a laggard.

Joe Biden has convened a meeting of 40 heads of government this week to "build momentum" ahead of COP26. The US clearly wants to assert some leadership on the green transition. They probably see China as their main competitor on this, as on many other issues, after Beijing's unexpected pledge last year to reach "net zero" by 2060. However, on the regulatory aspects, and especially on green finance, the real competitor may well be the European Union. The EU is ahead, but the US clearly want to catch up fast. An issue, in terms of collective welfare, is whether some harmonization towards a common benchmark will be possible to build.

Also, this week we look at the progress in the European vaccination programme, exploring some of the supply constraints ahead. We continue to think that ensuring collective immunity at the beginning of Q3 will be difficult and provide some quantification of the "tourism crash" of last summer.

The Green pincer movement

Fighting against climate change is one of the few areas where the US administration explicitly sees China as a potential partner. Since the two countries are the world's top CO2 emitters, this is both necessary and reassuring. A joint statement issued on Sunday 18 April, negotiated by John Kerry and Xie Zenhua, reflects a joint commitment to supporting the Paris agreement. But even on these matters' competition is never far from cooperation. Last September, China's pledge to be "net zero" by 2060 grabbed attention at a time when the Trump administration made it impossible for the US to contribute on these issues. Conversely, **Joe Biden's gathering of 40 leaders next week to "build momentum" ahead of the COP26 in November is obviously a way for the US to reposition itself as a leading force on climate action**. Biden has pledged to make the US "net zero" by 2050, a timeline aligned with that of the EU, and his administration's insistence on obtaining from Beijing an acceleration of its decarbonation process – this is being resisted so far, judging by the statement of China's Vice Foreign Minister last week - helps him to draw attention on the US progress.

Biden's main problem in trying to take global leadership on this essential matter is that the US track record is far from unblemished – including at times Democrats dominated the policy stance in Washington DC. The Obama-Biden administration failed to get a comprehensive carbon "cap and trade" framework through in 2010. It had been supported in the House but could not reach a majority in the Senate although the Democrats held a 9 seats majority. This administration's most concrete achievement – the Clean Power Act, which was designed to reduce CO2 emissions from electricity generations by 32% by 2030 relative to 2005 – came very late (it was unveiled in August 2015 only) and was in effect stopped by Donald Trump. Foreign leaders could be forgiven for doubting Biden's capacity to deliver concrete change domestically with only a one-seat majority in the Senate.

On green matters, focus has so far been on Biden's investment plan. Although it could indeed bring about spectacular changes, we think **some attention should be devoted to the new administration action via the regulatory agencies**. It is less an obvious "headline maker" than pledging billions of dollars towards renewable energy, and the legal ramifications are often complex, but it can be an effective accelerator of the green transition, either to bypass a reluctant Senate, or to pressure it into supporting the White House's investment package.

We start with the decision of the Environment Protection Agency (EPA) to reopen consideration of a national climate pollution cap. This is a crucial but long story, so buckle up!

In 2009, the Center for Biological Diversity (CBD) petitioned the EPA to set National Ambient Air Quality Standards (NAAQS) for CO2. In principle, it should not have been problematic for the EPA to add CO2 to the list, since the agency the same year had acknowledged that carbon dioxide, together with all the other greenhouse gases, *"threaten the public health and welfare of current and future generations"* in a public "*endangerment finding*". However, in the same document the EPA mentioned that "*these findings do not themselves impose any requirements on industry and other entities"*. At the time, the only concrete impact it had was to implement greenhouse gas emissions standards for vehicles. Conversely, **adding CO2 on the NAAQS list – which would not entail a Congressional decision - would go much further since it would force all 50 states to develop their own CO2 reduction strategy, with penalties in case of non-attainment**.

Still, the current NAAQS framework has been designed to deal with pollutants which can be curbed by *local* action, such as limitations to automobile traffic or changes in city-wide utility networks. Six pollutants have been identified so far: carbon monoxide, ground-level ozone, particulate matter, nitrogen dioxide, sulphur dioxide and lead. The NAAQS might not be the easiest conduit to deal with global warming which is best addressed by internationally coordinated nation-wide decisions. This may explain why the EPA under Obama ignored the petition. But the Trump administration went further and the previous EPA Administrator, Andrew Wheeler, officially denied the CBD petition just before leaving office in January 2021. This denial was then rescinded by the acting EPA administrator Nishida in March.

Rescinding the petition is only a promise to re-examine it, without any specific timeframe, but it may be understood as a "message to Congress" from the Biden administration. If Republicans and moderate Democrats block Biden's green investment programme, they could be faced with regulatory action which could be as – or even more – harmful to the interests of the fossil fuel industries, without even the benefits of federal investment for their constituents.

It is difficult to assess the seriousness of that threat, given the likely involvement of the Supreme Court. In an article otherwise very supportive of using the NAAQS to deal with carbon issuance, Crystal and others raised in the Georgetown Environmental Law Review the question of whether or not the Court could consider that greenhouse gases are so different from the other 6 pollutants that they would not fit the NAAQS framework, mentioning that *"some recent precedents suggest that where an agency initiative will have major economic impacts the Court will be skeptical that Congress authorized the agency to act unless the statutory language is unambiguous".* The authors conclude that there would be enough arguments for the Court to support the EPA, but the appointment of more conservative Justices could tip the balance. Still, the return of the NAAQS solution is another signal that Biden "means business" on his green agenda, and moderate Democrats and Republicans may not be ready to bet on a ruling of the Supreme Court "after the fact" and settle for a compromise with the White House on environmental matters.

Green finance is another area where the US administration is being more active. On April 9 the Division of Examinations of the Securities and Exchange Commission (SEC) issued a "Risk Alert" highlighting deficiencies and internal control shortcomings in Environmental, Social and Governance investing in financial advisors and fund managers. At this point, the SEC has never published a set of rules or guidance on ESG activities, and this "Risk Alert" coming after an announcement in February that the SEC would enhance its focus on climate-related disclosure in public company filings, may be seen as the beginning of a regulatory push in this area.

New competition for the EU?

The SEC stance on ESG is not fully settled yet, as an internal debate is clearly taking place. The two Republican members of the Commission, Hester Peirce and Elad Roisman, issued a joint statement in March, calling for caution on these matters. Commissioner Peirce issued another statement last week in which she warned against the concept of a global standard on ESG metrics. However, in a speech on 11 March, the Acting Director of the SEC Corporate Finance Division extensively discussed in a very nuanced way the merits of an internationally harmonized ESG disclosure framework. His conclusion was that *"the SEC can and should play a leading role in the development of a baseline global framework that each jurisdiction can build upon to address its individual needs".* No full harmonization then, but some sort of "minimum benchmark".

So far, the EU has been well ahead on these issues. A set of three interconnected EU regulations will offer a comprehensive framework. The "taxonomy" will define what constitutes a green activity, the Non-Financial Reporting Directive (NFRD) will guide companies on how to disclose their action in light of the taxonomy, and the Sustainable Finance Disclosure Regulation (SFDR) is clarifying the categories of sustainable investment products market participants offer to savers. By being the "first mover" on these issues, the EU could set up the global benchmark. Now that the US administration may be catching up with its own regulations, a key issue – in terms of collective welfare – is whether this could ultimately lead to a competition between different frameworks, or if a good measure of harmonization will be achieved. The US still has a lot on its plate to produce as comprehensive a framework as the Europeans, but even in the EU it is not fully implementable yet (the finalization of the taxonomy has been delayed and the NFRD won't be enforced before 2023).

On the green investment plan, the EU is also ahead thanks to the Next Generation Pact which has been agreed last year. Implementation continues to be a question mark though. Disbursements have not yet started and are still dependent on national ratifications. The German Constitutional Court has ordered on March 26 the President not to sign the bill after it was endorsed by a 2/3 majority in parliament, pending its examination of a lawsuit against the debt mutualisation the new framework entails. The news flow on the issue has been minimal since then, apart from reassuring words from German Finance Minister Scholz last Friday. A swift decision by the Court is a possibility, but another is that Karlsruhe would first request the opinion of the European Court of Justice (ECJ), but even this would not necessarily bring the procedure to an end since the German Court last year declared itself not necessarily bound by ECJ rulings. The dispute with the ECJ ultimately did not have any lasting consequences, but the whole process could end up delaying the materialization of the Recovery and Resilience Fund which came into political agreement in July of last year.

To make matters worse – and more complicated – the ratification process is also in jeopardy in Poland. PiS (Polish Law and Justice party) is dependent on two smaller parties for its parliamentary majority. United Poland's leader, Justice minister Ziobro, repeated that his parliamentary group would oppose it since they consider the compromise on "rule of law "issues brokered with the Polish and Hungarian leaders is unacceptable. The Prime Minister stated that the refusal of United Poland to support this bill would spell the end of the coalition.

PiS can probably count on support from the liberal and left-leaning opposition to get the bill ratified, and we are reasonably confident the Recovery and Resilience Facility (RRF) will be able to start disbursing in the second half of this year, but **the whole painful process is creating an "image problem" for the EU given the contrast with the activism in Washington DC**. Biden may be in a competition with Xi for global leadership, and this extends to the fight against climate change, but in all this the EU's strong credentials – it is already a far smaller CO2 emitter than the US and China – are drowned in the noise.

The arithmetics of constraints

Greening monetary policy is also an area in which Europe is ahead of the pack, at least in terms of propositions. Ironically, this is being put in more focus now as a lawsuit against one of the members of the Eurosystem, the National Bank of Belgium, is the object of a lawsuit by an non-govermantal orgnisation (NGO) for failing to contribute to "the protection of the environment and human rights" through its corporate bond buying programme which, the plaintiff argues, is inherently biased in favour of large carbon emitters.

Before the case goes to the European Court of Justice – the explicit ultimate goal of the NGO which filed its complaint in the Belgian justice system – we suspect the European Central Bank (ECB) will have concluded its strategy review and will have effectively greened its monetary policy framework. Some commentators have argued that this would unnecessarily burden the central bank which is already dealing with enough constraints to deliver on its goal – price stability. Our view is that the European Treaty made it clear that "without prejudice of its price stability objective" the central bank can "contribute to the other objectives of the EU". Given the EU's strong sustainability agenda, it probably makes sense for the ECB to tweak its operational framework to help along as long as it does not impair its capacity to deliver on its inflation goal. We would however reiterate a point we have been making since the start of Macrocast two years ago: the thorniest question the ECB will have to the solve as the Euro area makes progress towards "net zero" is how to accommodate the impact this could have on inflation. Indeed, if the price of carbon rises on trend, it may lift average consumer prices beyond what would be the result of the "endogenous working" of the economy.

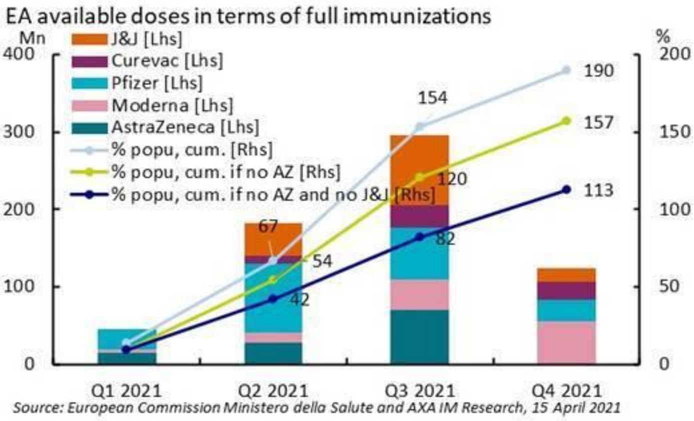
Anyway, the ECB's Governing Council meeting this Thursday is likely to focus on more prosaic issues. There is no major expectation for the April rendez-vous. Focus is on the ECB's response to market pressure, and peace and quiet has reigned on this front since their last meeting. Besides, the central bank has made it clear that it would prefer to adjust – if needed – its stance only when a new batch of forecasts becomes available, and the next one will come in June only. We suspect the main interest on Thursday will lie in Christine Lagarde's characterization of the current economic situation. We think she will "accentuate the positives", now that the Euro area is making good progress – at last – on the pace of vaccination.

Indeed, progress on EU inoculations is confirmed. In our previous issue of Macrocast, to avoid the Easter break disturbance we used the data pertaining to the last week of March to get a sense of the time it would take to get to collective immunity. Reassuringly, the data for the week to 15 April point to another acceleration. If they can maintain the same pace, France, Germany and Italy can have 50% of their population covered with at least one shot in less than 100 days, and in all cases, by the end of September the 75% threshold could be hit. This is another demonstration that the EU can deal with the logistical and public trust issues of vaccine distribution. The area of focus now is squarely vaccine supply.

More countries have banned outright – e.g. Denmark – the use of Astra Zeneca or restricted it to some segments of the population. In any case, the rollout of the Astra Zeneca continues to be hampered by production mishaps. J&J is expected to provide a significant contribution – 23% of the total in Q2 and 31% in Q3 – but for now shipments to Europe are suspended as the US authorities are looking into this vaccine's side effects. We thus need to assess the "room for manoeuvre" healthcare authorities have in the EU if one or several vaccine suppliers cannot fully deliver.

According to the breakdown published by the Italian Health ministry, the total, "maximum supply" currently contracted would be enough to fully vaccinate 67% of the population in the EU (here we count 2 doses per head except for J&J) by the end of Q2 and 154% at the end of Q3 (Exhibit 1). This would fall to 54% and 120% respectively without Astra Zeneca, and to 42% and 82% with Astra Zeneca and J&J both excluded, taking into consideration the recent announcement of an intensification of the deliveries by Pfizer. A vaccination rate of 82% of the total population would be consistent with most estimates of the level needed to provide "collective immunity" at the time when the historical version of the virus was dominant. It may be a bit "short" if more variants appear.

Exhibit 1 – we can lose one, losing two makes it complicated



In any case, given the supply constraints, expecting to reach collective immunity at the beginning of Q3 – with the peak of the tourism season in Europe – would be a stretch. This is key. We can use the "travels" item of the balance of payment to estimate the impact of another "bad tourism season" this summer (Exhibit 2). In Spain or in Greece, the impact on GDP last summer was very significant (4% and 15% in yoy terms respectively, Exhibit 3).

Exhibit 2 – Tourism is key to the Southern EU countries

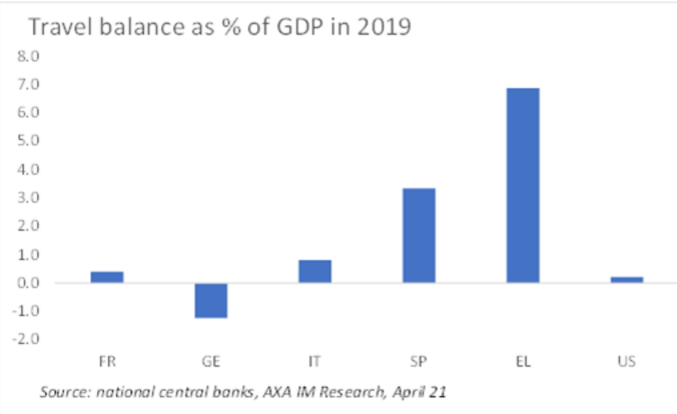
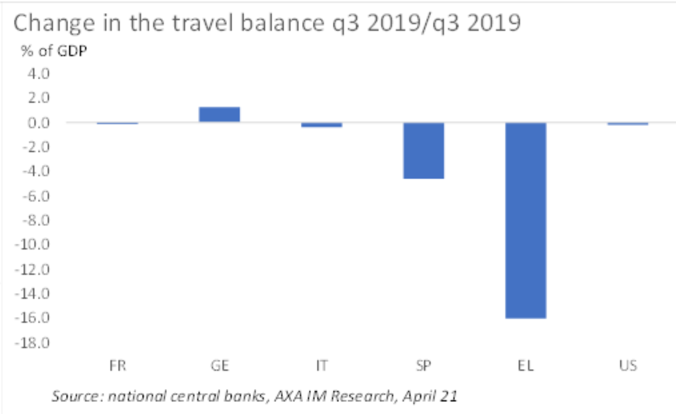


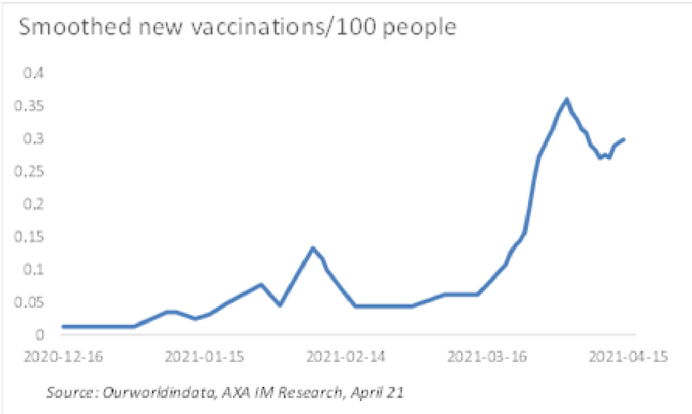
Exhibit 3 – Another bad season would exacerbate intra-EU divergence



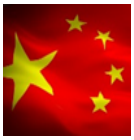
The EU is working on a "sanitary passport" but if the vaccination programmes are not complete, and/or variants continue to emerge or become prevalent in Europe, tourists could prefer the relative safety of their home country. In any case it may be difficult to count on non-European tourists.

While Europe is accelerating on its vaccination programme, progress is slow in several emerging countries, including in China. The swift normalization of economic activity after the first wave has shifted focus away from monitoring sanitary conditions there. Still, the mediocre GDP growth rate in Q1 2021 reflects to a large extent the fact that mobility had been severely curtailed during the lunar year holidays. China has outperformed the other key economies by minimizing the disruption to activity brought about by fairly severe restrictions, but its own progress towards collective immunity is not particularly striking. Actually, the pace of vaccination has slowed down since the beginning of April (Exhibit 4) and the cumulative inoculation per head ratio is now below that reached in Europe. It seems that this can be traced back to the very success of China's in curbing the virus circulation: people simply don't see the need to get vaccinated.

Exhibit 4 – a slowdown in vaccination in China



This adds new concerns to the pace of global normalization, with a potential specific impact on the Euro area given its reliance on exports. After a slow start last spring, the rebound in Chinese demand contributed nicely to the recovery in manufacturing activity in Germany. We have been warning against counting too much on a further acceleration in the contribution of China to the European economy given the choice by Beijing of a cautious policy stance – reflected in the latest data on money supply in China. If on top of this we need to factor the continuation of some restriction to mobility over there to offset the slow take off of the vaccination programme, this will add to the headwinds which continue to blow in Europe.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• March retail sales posted sharp 9.8% monthly rise, largest since May 2020 • Industrial production rose by 1.4%mom, manufacturing by 2.7% in March • We revised Q1 GDP forecast to 8.7% from 6.6% annualised (full year to 6.9% from 6.5%) • CPI inflation rose to 2.6% (Mar) – 2018 high. Expect annual rate >3% in coming months • 5-10yr inflation expectations eased to 2.7%	• Initial jobless claims – these fell sharply to 576k, but we suspect Easter seasonal impact and will watch for rebound • March's home sales data watched, rebound expected post-February weather, but mortgage applications fell across March • Debate on infrastructure package • Virus rates, particularly in Michigan
	• EU released details of issuance plan for NGEU: maximum amount to reach €800bn up to 2026, with annual target of €150bn • BioNTech/Pfizer to deliver an extra 50 million doses in Q2 and EC negotiating a 1.8bn doses contract for 2022/23 • EA IP dropped 1%mom	• Italian government likely to approve a new aid package worth €40bn • Uneventful ECB meeting: ECB likely satisfied with the effect of PEPP purchases increase, but unlikely to clarify its reaction function, internal disagreement as shown in the minutes implies little forward guidance. June meeting to be key
	• UK GDP rose by 0.4% in Feb, but Jan revised higher to -2.2% from -2.9%. The outlook for Q1 revised up to -2% and full year to 5.3% • Fed trade data recorded rebound in EU exports in Feb, but still 15% lower than Dec. • BoE Credit conditions survey, showed soft HH, but strong corporate demand for credit	• CPI inflation expected to rise in March – consensus 0.8%, we see upside risk – part of base effect rise to around 2.5% by Q3 2021 • Unemployment rate (Feb) expected to remain subdued at 5.1% due to furlough • Retail sales (Mar) lower risk to 1.8% consensus • Prelim estimates of April's PMI surveys
	• Renewed restrictions in big cities for 1 month • Mar corporate good price rose by 0.8%mom • Feb machinery orders surprised on the downside at -8.5%mom (consensus: +3%) • April IPSOS consumer sentiment is stable without taking into account latest restrictions	• March trade figures are expected to rise but they will be distorted by basis effect • March CPI is likely to rise as discounts from the "Go to" campaign are still in standby while volatile components such as energy price have risen substantially on a yearly basis
	• Q1 growth rebounds strongly on low base but slows on a sequential basis due to virus resurgence. Growth drivers rebalance, with March retail sales surprising on the upside	• Credit market awaits nervously information on Huarong – a major state-owned bad-debt manager who has been plagued by rumours of imminent default
	• Central banks were on hold last week in S. Korea, Singapore (more hawkish) and Turkey (more dovish) • Elections in Peru: Castillo (far left) vs Fujimori (right) to run for 2nd round presid. on 6 June • Ecuador president elected Lasso • New US sanctions on Russia	• CB meeting: Indonesia (on hold), Russia (another hike likely on the back of inflation rising and rising geopolitical tensions) • March CPI in Malaysia; mid-April CPI in Mexico • March IP in Taiwan, SA • S Korea first 20-days exports

Upcoming events		
	US:	Thu: Jobless claims, Existing home sales (Mar), Leading index (Mar); Fri: Mfg PMI (Apr), Serv PMI (Apr), New home sales (Mar)
	Euro Area:	Tue: EA Bank lending survey (Q1); Thu: ECB meeting, Fr mfg confidence (Apr); Fri: EA Comp, mfg, serv PMI (Apr), Ge, Fr mfg, serv PMI (Apr)
	UK:	Tue: Unemployment (ILO, Feb); Wed: CPI (Mar); Fri: GfK consumer confidence (Apr), PSNB (Mar), Retail sales (Mar), Comp, mfg, serv PMI (Apr)
	Japan:	Mon: Trade balance (Mar), IP (final, Feb); Fri: CPI (Mar), Mfg PMI (Apr)
	China:	

Our Research is available on line: http://www.axa-im.com/en/insights

AXA Investment Managers SA
Tour Majunga – La Défense 9 – 6 place de la Pyramide 92800 Puteaux – France
Registered with the Nanterre Trade and Companies Register under number 393 051 826