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Climate, Finance, and Geopolitics

Human Self-delusions and the Challenges for Europe

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Key Takeaways

- Finance, climate science and geopolitics were once separate subjects. Now linked, their commonality is that they reveal the illusions of men who, in the 20th century, thought they had mastered finance, tamed nature, and prevented war.

- The financialization of the economy, climate change and the resurgence of armed conflict have exposed these illusions and calling for a new awakening.

- With planetary limits about to be reached, it will not be enough to rely on finance alone. Similarly, the rise in geopolitical risks calls for resources which, in a context of high indebtedness, are no longer available to governments.

- For Europe, which is facing to these challenges without being solidly constituted, the challenge is even greater, but across the globe it is high time to ask questions about exacerbated national sovereignty and the lack of respect by governments for the commitments they have made.

Introduction

The combination of geopolitical tensions, climate disruption, and the growing role of finance in the economy is taking us into uncharted territory. Until recently, each of these subjects was handled separately, but they are now inextricably linked by two shared characteristics: the gravity of the threat, and the fact that they all lay bare the scale of human self-delusions. There are also interactions between them: between climate and finance, since states have a tendency to pass this "hot potato" onto the private financial sector; and between geopolitics and finance, because money remains the "sinews of war" and debt is a vulnerability, especially for any actor wanting to exercise full sovereignty. These issues are particularly acute for the European Union (EU) that is still a work in progress.

A trio of self-delusions

In the 20th century, humankind believed it could simultaneously control finance, tame nature, and prevent war. Being aware of its own limitations does not prevent it from asking for more time to settle its mistakes.

For several decades, the link between the growth in monetary wealth and growth in production has been broken.[1] This "financialization" of the economy not only poses a threat to stability—notably because the non-banking financial sector remains less regulated than the banks—but is also why, in a period of low interest rates,[2] savings are channeled into quick profits rather than productive investment. According to the International Monetary Fund (IMF), global debt (both public and private) now stands at 238 percent of global gross domestic product (GDP).[3] After the Covid-19 pandemic, central bank balance sheets soared (with the European Central Bank [ECB] alone holding €5.5 trillion in monetary-policy related assets). The idea of an indefinite increase in credit has become entrenched, despite the fact that a dual commitment to control public deficits and debts, and not to monetize national debt, is enshrined in the EU treaties. The ECB has since raised interest rates and started selling off its bond holdings, but indebted governments and companies will find it difficult to wean themselves off cheap money. The European Commission's efforts to improve enforcement of budgetary discipline are this far not successful.

The "financialization" of the economy poses a threat

1. See in particular J. de Larosière, *En finir avec le règne de l'illusion financière*, Paris: Odile Jacob, September 2022, which is based on a McKinsey study, "The Rise and Rise of the Global Balance Sheet", November 2021.
2. And even some negative interest rates in Europe.
3. V. Gaspar, M. Poplawski-Ribeiro, and J. Yoo, "La dette mondiale retrouve sa tendance à la hausse", IMF Blog, September 13, 2023.

Finance is not the only sphere in which humans have lost touch with reality. They also believed that the economy was free from constraints: engineers thought they could increase agricultural and industrial yields ad infinitum, companies that they could increase their profits by offshoring production, and consumers that they could accumulate endless "stuff" without worrying about the depletion of natural resources. In recent years, scientific reports (from the Intergovernmental Panel on Climate Change [IPCC][4] and the Intergovernmental Science-Policy Platform on Biodiversity and Ecosystem Services [IPBES][5]) have rung alarm bells and called for a rethink of the old model.

We thought we had mastered nature, but are now realizing that our "planetary boundaries" have been or are about to be crossed".[6] While billions of people still do not have enough to live in dignity, humanity as a whole is already living beyond its means. There is increasing awareness of this: companies, governments, and individuals are making efforts to decarbonize, protect nature, and ban plastics, but their progress is slow and heavy going. At the global level, energy requirements continue to grow, and coal and hydrocarbons are still being burned. Some political parties, like lemmings ready to jump off a cliff, are still denying the gravity of the climate and biodiversity situation.

> Our "planetary boundaries" have been or are about to be crossed

Finally, after the Second World War, those in power set out to create a new world order founded on universal values, centered on the United Nations (UN) and the Bretton Woods Institutions (the IMF and World Bank). They believed that national sovereignty and international law would ensure the peaceful coexistence of peoples and stability in a world striving for cooperation, with the UN Security Council as the supreme arbiter of global affairs. But this body, paralyzed by use of the veto by its permanent members, has failed. In 2022, one of them (Russia) violated the UN Charter by waging a war of aggression, with little condemnation from the "Global South". Emerging countries continue to demand a greater say in global decision-making, proportionate to their current economic and political weight. As the development of the BRICS (Brazil, Russia, India, China, and South Africa) has shown, there is growing opposition to the post-war multilateral model, the values of which are seen as more Western than universal. In June 2023, at the Summit for a New Global Financial Pact in Paris, Brazilian president Lula called for an end to the unequal world order dominated by the old powers, and sharply observed that it was not for others to tell him what to do in the Amazon.

4. "Sixth Assessment Report", *IPCC*, March 2023.

5. "Global Assessment Report on Biodiversity and Ecosystem Services", Summary for policymakers, *IPBES*, 2020.

6. W. Steffen, K. Richardson, J. Rockström, *et al.*, "Planetary Boundaries: Guiding Human Development on a Changing Planet", *Science*, Vol. 347, No. 6223, 2015. Nine biophysical processes regulate the stability of the planet: climate change, biosphere integrity, the nitrogen and phosphorus cycles, land-system change, ocean acidification, freshwater use, stratospheric ozone depletion, atmospheric aerosol loading, and the introduction of novel entities into the biosphere.

Everywhere companies, public authorities and people are calling for "more time". There is no doubt that it is difficult to suddenly reduce carbon consumption, to overhaul the global order, or to reduce debt at a time of growing requirements for the green transition and military equipment. But is it not madness to think that the needs will provide the means, without any attempt at sobriety or restraint?

We are also told that it would be "unrealistic" to challenge the sacred cow of national sovereignty. Must we therefore accept a world in which states violate their commitments to combating climate change and protecting nature, fail to guarantee peace in Palestine or Ukraine, and pile up debt? Is the juxtaposition of national sovereignties so effective that it must serve as our horizon, without any form of scrutiny? There is no appetite to open up any debate on global governance or tougher enforcement of pledges, since those in power have a conflict of interest. Across all continents, the political debate is not resulting in greater clarity, but rather inflaming nationalist sentiments and encouraging us to bury our heads in the sand.

Fear of street unrest or electoral disaster is delaying the introduction of a carbon price and all the necessary taxes and bans. In principle, of course, the carrot is always preferable to the stick, and it is always easier to laud national sovereignty than to share it, but are we objectively still at that point? The urgency of the situation—in climate, geopolitical, and financial terms—calls for immediate action. On the climate front at the very least, since we know that there is a limited amount of carbon dioxide (CO_2) left to emit before the world tips over into chaos, we need to tell the truth and declare a general mobilization, coupled with banning emissions and deforestation, stopping plastic production, and taxing the most carbon-intensive products such as sport utility vehicles (SUVs) and meat-based foods. Without equating climate change and excess of debt, it is also true that debt cannot be unlimited: at some point it must be repaid, and the higher interest rates rise, the greater the burden.

> The urgency of the situation—in climate, geopolitical, and financial terms—calls for immediate action

There is no supreme authority that can give humanity "more time", particularly when it comes to the ecological transition. Extreme weather events and wildfires of unprecedented severity are signs that nature is already beginning to take its revenge. But the same is also partly true of the excessive financialization of the economy: if the financial system were to collapse, the social conflagration would be equally devastating. After decades of deluding ourselves, the only true "realist" approach is to recognize what is happening in each of these three areas, which may be different but all reveal the same tendency to *hubris*. Even if we develop new technologies to help tackle the energy transition, the planet is approaching the point of no return.

These three subjects, so bound up in human self-delusions, are also very much interlinked, and two major relationships emerge: finance and climate; and geopolitics and finance.

Finance and climate change: How to pass the "hot potato"?

There are three main areas in which finance has a role to play in the transition to a zero emissions world.

First, this transition will require major investment, including from private capital, particularly given that states are already over-indebted and reluctant to honor their existing commitments. At COP15 in Copenhagen in 2009, developed countries committed to channeling $100 billion a year into climate action in the Global South by 2020, but to some frustration, this target is now not expected to be met until 2023/2024. The official development assistance mechanisms represented by the World Bank and development banks, whose capital is underwritten by states, are playing their part in the collective effort to combat climate change and adapt to new living conditions. But the amounts required are so staggering—many analyses refer to sums in the trillions—that public money is simply not enough.

The 2022 Songwe-Stern report, for example, concluded that the world needed a breakthrough and a new roadmap on climate finance in order to mobilize the $1 trillion a year that will be needed by 2030 for the transition of emerging markets and developing countries (other than China).[7]

Second, financiers have recognized expertise in risk analysis. In a now-famous speech given back in 2015, Bank of England governor Mark Carney identified three main types of risk from climate change: physical risks, transition risks, and liability risks. The physical risks are already materializing, with heatwaves, wildfires, and floods of unprecedented severity causing damage to homes, factories, and farms. Forests are absorbing less CO_2. The transition has begun, but not without resistance: in the United States (US) for example, some states are demonizing environmental, social, and governance (ESG) policies, and thus preventing asset managers from "greening" their portfolios.

Third, finance is a legally regulated activity: by requiring detailed information about transition plans, for example, in the name of investor protection, governments can help make finance greener. They can also oppose "greenwashing", in which investors are misled about what is being done with their money. The performance of certain asset managers in this respect has been disappointing.[8]

7. V. Songwe, N. Stern, and A. Bhattacharya, "Finance for Climate Action: Scaling Up Investment for Climate and Development" (Report of the Independent High-Level Expert Group on Climate Finance), London Grantham Research Institute on Climate Change and the Environment/London School of Economics and Political Science, 2022.

8. See, for example, N. Megaw, B. Masters, and M. Darbyshire, "Blackrock Hit by Backlash after Fall in Environmental and Social Votes", *Financial* Times, August 26, 2023; and G. Smith, "FirstFT: Vanguard Adds to ESG Backlash", *Financial Times*, August 29, 2023.

Central banks have begun to get to grips with these issues. Since 2017, the global Network for Greening the Financial System (NGFS) has been looking at the questions raised, promoting sharing of knowledge and best practice, and conducting climate risk "stress tests" on banks. While this work is to be commended, it has thus far essentially consisted of pilot schemes and voluntary sharing of best practice, and there is scope to take it much further (in France, for example, by rapidly developing a rating of companies by their climate/environmental performance). Some experts argue that the tools currently available are insufficiently precise: while such scrupulousness is to their credit, perfect is sometimes the enemy of the good. Like everyone else tackling these issues, the public authorities (legislators, central banks, and supervisors) are having to feel their way through. Others argue that climate-related work is detrimental to the mandate of central banks (price stability), but since the climate transition has a major impact on inflation (via energy, food, and household appliance prices[9]), it is difficult to see how these institutions can ignore it. Rating sovereign issuers on their climate and environmental policies would be both useful and justified, since states make commitments in international forums.

The climate transition has a major impact on inflation

Governments also have tools at their disposal that the financial sector does not, such as the ability to end public subsidies for carbon-intensive sectors (for instance, intensive agriculture) or the use of fossil fuels (support for road transport or households). Public money is too scarce to be misused. They could also—at last—introduce the global carbon price advocated by many leading economists.[10] Carbon markets do exist in some individual countries (Sweden, for example) or regions (such as the EU Emissions Trading Scheme [ETS]), but these initiatives are unfortunately too localized, and while the introduction of the adjustment at the EU border will help prevent the "leakage" of carbon-based activities out of the EU, this mechanism will take several years to become effective.

In terms of protecting nature, governments could also introduce more systematic measures to reduce the "negative externalities" of globalization (such as the tax-free shipping sector, land take, and consumption of water and natural resources). It is remarkable that, despite the damage they cause, CO_2 emissions have never been banned anywhere in the world, and are only now beginning to be restricted (for example with the EU ban on the sale of new internal combustion engines by 2035). A number of legal tools also exist to protect nature (deforestation is sometimes banned outright, or via laws protecting indigenous lands); the EU recently adopted crucial rules on importing goods linked to deforestation, but these could have adverse consequences if small producers are excluded from traceability schemes.[11]

9. See in particular the speech by Isabel Schnabel, "A New Age of Energy Inflation, Climateflation, Fossilflation, Greenflation", Frankfurt: European Central Bank, March 17, 2022.

10. They include Jean Tirole and Christian Gollier at the Toulouse School of Economics, among others.

11. A. Hancock, "EU Deforestation Rules Risk 'Catastrophic' Impact on Global Trade, Says ITC Chief", *Financial Times*, August 20, 2023.

In December 2022, governments also approved the Kunming-Montreal Global Framework for Biodiversity.[12] We therefore need to stop treating climate and nature separately: in nature, too, the risks are so high that they affect the financial sector (for example with changes in agricultural land or plant species reducing yields, and the increase in invasive species).

In short, while finance has a role to play, it cannot save the planet alone: first, because it is the very defense of humanity's "common goods", as defined by economic theory, that is at stake, a task to which certain market instruments are ill-suited; and second, because finance usually has a short-term horizon, whereas ecological action must think in the long term. Finance must therefore complement, rather than replace, public action. The financial sector will be better able to play its part in decarbonizing and protecting nature if the public authorities send coherent, systematic, and sustainable signals. Finally, it would be strange to expect any debt limitation while the financial sector drawns its revenue from credit.

In addition, finance alone cannot make up for the weaknesses of states in a period of geopolitical tensions.

Geopolitics and finance: The "sinews of war" and the Achilles' heel of the EU

British historian Paul Kennedy, whose work includes studies over the long term, has taught us the importance of economic strength as a basis for power.[13] If the EU wants to compete on the global stage with large powers , it needs to continue making the grade in terms of its economic performance. But instead of that, a gap has opened up between the EU and the US.

This economic gap is a recent and dramatic one: in 2000, Americans had equivalent living standards to Europeans, but are now richer. Since 2008, the US has grown by 28 percent, and the EU by 15 percent. Essentially, since the global financial crisis— that begun in the US, but did more damage on this side of the Atlantic—we have fallen behind. We are paying dearly for the dillydallying of governments in handling the crisis: there is a cost to the lack of common action at the EU level, or "non-Europe".

The US also has technological superiority: of the twenty most valuable companies in the tech sector, fifteen are American, and only two are European (the rest are in Asia).[14] In military terms, Europe is overwhelmingly dominated. As described in a report by researchers from the European Council on Foreign Relations, the continent is allowing

12. "Kunming-Montreal Global Biodiversity Framework", *UN Environment Programme*, Convention on Biological Diversity, December 19, 2023, available at: www.unep.org.
13. P. Kennedy, *The Rise and Fall of the Great Powers: Economic Change and Military Conflict from 1500 to 2000*, New York: Random House, 1987.
14. "Macroeconomic Scoreboard", Eurofi, September 2023.

itself to be "vassalized".[15] The figures speak for themselves: the US spends $830 billion a year on its military, and China spent almost $300 billion in 2022[16] (with the caveat that Chinese government statistics are not wholly reliable, we should note the rapid growth in this figure and the relatively low level of Chinese unit costs). Aggregating all military spending by its member states puts the EU roughly on a par with China: a sum that, while not to be sniffed at, is somewhat misleading since there is no unity of operational action across the bloc. The EU is also yet to achieve energy independence.

The US certainly has its own weaknesses: it has a huge national debt (over $30 trillion), and adopting the federal budget is a laborious process since the administration has to regularly request specific authorization to lift the ceiling. The role of the dollar is openly challenged by the BRICS, led by China and Brazil. While US treasuries may be popular, this is perhaps less because of their intrinsic qualities (and the solidity of American institutions) than the lack of alternatives. No other sovereign debt market can rival the US in terms of depth or liquidity. While the NextGenerationEU (NGEU) fund has helped create a burgeoning market in euros, European debt issuance remains fragmented, with member states' debt competing on the markets without offering sufficient depth.

The EMU has never tried to leverage its currency for global influence

Among the many factors explaining the gap between the EU and US, analysts often point to the existence of dynamic capital markets in the US, which result in better allocation of resources and, in particular, easier financing for military and civil research.

Meanwhile, the EU's Economic and Monetary Union (EMU) remains an unfinished project. The financial sector was not considered central to the Maastricht Treaty, which made no provisions for managing a financial crisis, or for creating a financial center, EU financial actors, or the optimal allocation of resources. The EMU has never tried to leverage its currency for global influence. The euro accounts for around 20 percent of global central bank reserves, which is a decent share, but lacks a single representative at the IMF, and in the bodies that set financial standards (such as the Basel Committee on Banking Supervision, and the International Organization of Securities Commissions in market regulation).

The economic policies of eurozone countries also remain fragmented, and shared commitments are still too often flouted to strengthen overall credibility. The ambition of "European sovereignty" also encompasses economic performance and management of the public finances, but this is sometimes forgotten in certain capitals. Government debt-to-GDP ratios range from less than 20 percent (Estonia) to over 150 percent (Greece),

15. J. Schapiro and J. Puglierin, "The Art of Vassalisation: How Russia's War on Ukraine Has Transformed Transatlantic Relations", *ECFR*, April 2023.
16. Source: SIPRI Military Expenditure Database, Stockholm International Peace Research Institute.

and far exceed the 60 percent ceiling in France, Italy, Spain, Belgium, and Portugal, among others.

The breach of eurozone rules has already fueled populism: in Italy and France, where some people think that this lack of seriousness is here to stay; and in Germany, where the lax attitude of other member states has resulted in the rise of the Alternative für Deustchland (AfD), a party that was founded by a group of exasperated economics professors during the sovereign debt crisis of the 2010s, but has now become radicalized, anti-EU, and xenophobic.

US investment banks have also steadily gained market share in Europe, to the detriment of local firms. The EU banking union project has led to the creation of institutions such as the single supervisory mechanism (SMM) and the single resolution mechanism (SRM), but has not resulted in the development of a pan-European banking sector, since too many "host" member states (i.e., of banks from other EU countries) require capital to be located on their territory, in violation of the spirit of the single market. If the EU were to eventually get its capital markets union up and running, with the necessary tax and bankruptcy rules, the EU's abundant savings would finally go into financing the ecological transition and innovation within the bloc, rather than into US Treasury bonds or other foreign investments.

The world needs a new, more balanced, and fairer financial order

The world needs a new, more balanced, and fairer financial order. But this will only come about if the EU is able to create a single market for financial services that puts it in an influential position in this sector from which it can defend both its interests and its values. Obsessed with national rivalries within the eurozone, governments have failed to think about how they want to project the EU and the euro on the global stage. How can the bloc close the economic gap that has opened up over the past fifteen years between it and the US (and part of Asia)? How can the EU develop the financial tools it needs for technological and military independence, and for maintaining its social model? Curiously, talk of "European sovereignty" has focused mainly on defense and industrial policy; despite its strategic importance, finance has rarely received the attention it deserves.

Sovereignty presupposes the existence of banks and other financial actors capable of adding value to savings. It also requires control over market infrastructure (such as clearing houses, stock exchanges, and brokers). A textbook example of our collective impotence was the way in which, in 2018, the US forced European firms to cease all trade with Iran, even though the EU had no intention of abandoning the nuclear deal from which President Trump had unilaterally withdrawn. Trump exploited the role of the dollar as the leading global currency of exchange, but also his control over the "pipes" (the Swift network for financial transactions, despite this organization being based in Belgium). The alternatives to the Swift network that have since been developed have resulted in the recent sanctions against Russia having less of an effect than the West would have liked.

Finally, how can the EU pursue a sovereign policy when its budget has to be agreed unanimously, with no transparency, and is limited to 1 percent of member states' collective wealth? The NGEU fund represents the first significant attempt to provide the eurozone with the budget it needs, but this is a one-off, post-Covid instrument that is not intended to be made permanent. Without a budget, the EU cannot create a shared euro securities market, even though the European Stability Mechanism (ESM) rescue fund and some European institutions have issued supranational bonds. As long as the majority of euro securities are still used to fund the national budgets of the countries that issue them, the EU will remain a secondary actor in global finance. Only a market with great depth can provide access to cheaper financing and provide an international power base for the euro. In a world of states with a single currency, foreign policy, and military, EU members are weakening themselves by playing to their separate strengths.

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This kind of combined look at climate, geopolitics, and finance, which is all too rare, shows the scale of the task faced by the EU if it is to achieve strategic autonomy. The joint overview leaves a somewhat dizzying impression, since each of these three subjects reveals past failings and current threats. At any rate, given the extent of previous errors and self-delusion, we have considerable scope for improvement, particularly in Europe.

EU members are weakening themselves by playing to their separate strengths

Heightened nationalism, along with open conflicts (between Russia and Ukraine, and Israel and Palestine) and latent ones (between the US and China), makes the EU's task more difficult. But the likelihood of a major climate or financial crisis is such that certain obstacles to EU integration should be seen for the trifling difficulties they are. Developing leading financial actors, gaining control over financial infrastructure, making more of the euro and the single market, and equipping the EU with a proper budget are certainly all major challenges, but they are also opportunities on which the member states should seize. By doing so, they will not only help realize the ambition of European integration, but also enable the EU to continue acting as a beacon of cooperation and peace amid a world in turmoil.

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