Macro Focus

The green taxonomy: a driver for the transition

- New EU disclosure rules will reduce greenwashing and speed up the green transition
- Modest effects on rates in the short term, but large impact in the long run
- Green trends boosted in the Nordics; direct effects in the Baltics will be smaller

The EU is launching important regulations for greening the financial markets. The green taxonomy will define green investments and increase companies' environmental disclosure. The climate related parts of the taxonomy are to be finalized soon. Among financial market participants, the disclosure regulation will foster transparency on ESG issues. Though the regulations will inevitably have their shortcomings, they will reduce greenwashing and support funding to green projects. In the short term, we expect the regulations to have modest effects on interest rates, but their effects on stock prices and long-term funding costs could be considerable. In the Nordics, the taxonomy will boost the existing green investment trends and has potential to support the industrial transition. Overall, the Nordic economies are in a good position to gain from green investment, but some sectors will lose out. In the Baltics, with fewer large companies, the effects will be smaller in the near term.

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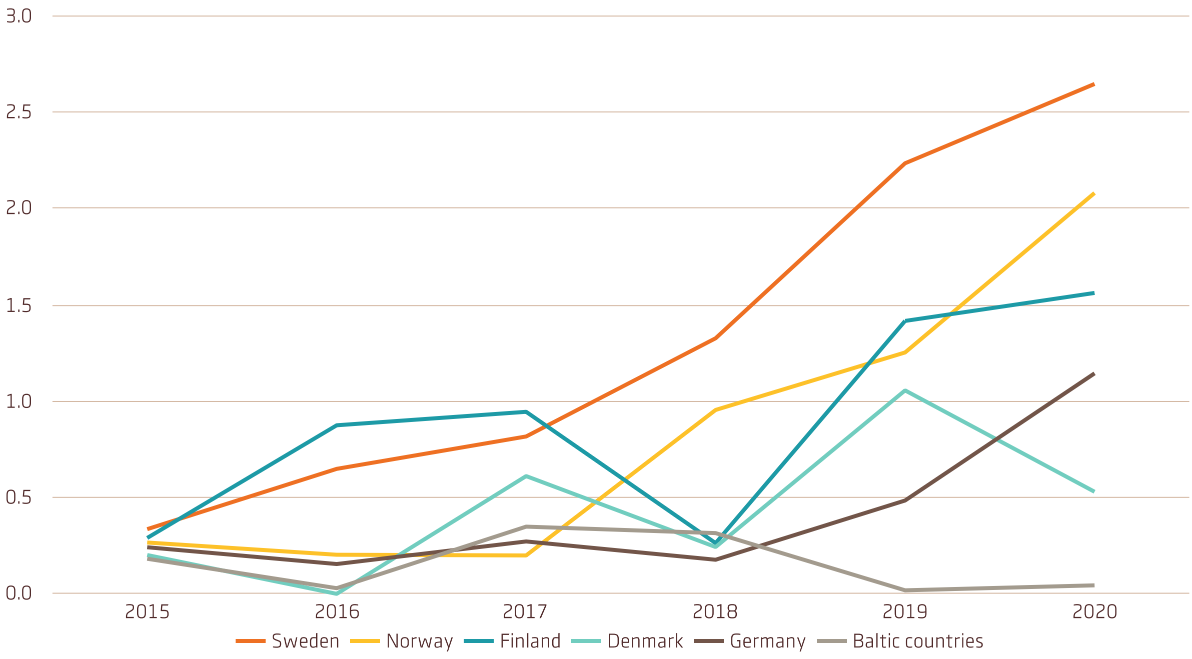
Green bond issuance

% of GDP



Sources: Swedbank Research & Macrobond

The EU Taxonomy: defining "green" economic activities

As a part of EU's Action Plan for financing sustainable growth, the EU Commission is working on **an EU Taxonomy**, a classification system for sustainable economic activities. The purpose of the taxonomy is to help investors, businesses, and EU Member States target funding in environmentally sustainable projects and reduce greenwashing. The EU's Action plan on sustainable finance also includes the Disclosure Regulation and the Low Carbon Benchmark Regulation.

The EU Taxonomy regulation defines criteria for a number of key industries to determine whether an economic activity and any investment products associated with it can be classified as environmentally sustainable. To qualify as sustainable under the taxonomy, economic activity must contribute to one or more of **the six environmental objectives**[1] set out in the Taxonomy Regulation, without significantly harming any of the other environmental objectives. It must also be carried out in compliance with minimum social safeguards and comply with technical screening criteria established by the Commission.

In addition to the activities that themselves contribute to one of the six environmental objectives, transition and enabling activities are also eligible to the classification system. Transition activities include activities for which there are no feasible low-carbon alternatives, but which support the transition to a climate-neutral economy. Enabling activities enable other activities to make a substantial contribution to one or more of the environmental objectives.

The Commission needs to **adopt technical screening criteria for each of the six environmental objectives.** Draft technical criteria for the climate parts of the taxonomy, which specify the "green" activities in detail, were published in November 2020. However, the rules are currently being reworked. The new draft rules for the climate parts have been postponed to the end of April, while the technical screening criteria for remaining areas should be ready by the end of 2021.

The taxonomy regulation will impact all participants in the European capital markets that are active in taxonomy-relevant sectors. From 2022, all companies listed in the EU with more than 500 employees, that are already required to provide a non-financial statement under NFRD[2]must report on their activities related to the six environmental objectives. Financial market participants are also required to report the proportions of investment products that are classified as green. Smaller firms are indirectly impacted by the regulation due to these disclosure obligations on asset managers.

The EU Taxonomy regulation and other regulations

The Disclosure Regulation requires financial market participants to disclose how and to what extent they have used the Taxonomy in determining the sustainability of the underlying investments. The Disclosure regulation also mandates financial market participants to address the environmental sustainability of their investments, the origins of ESG claims, and the risks the investments present to ESG factors. In general, the disclosure regulation has a broader perspective than the taxonomy regulation and covers all investments, including bank loans. In addition, under **the new Low Carbon Benchmark Regulation** benchmark providers (except interest rate and foreign exchange benchmarks) have since April 2020 had to disclose whether and how they take ESG factors into account.

Effects of the EU taxonomy

Can the EU taxonomy really make raising funds for green activities cheaper and reduce greenwashing? Theoretically, the taxonomy should help "green" companies and activities get lower funding costs due to lower perceived risk among investors. However, in the current low interest rate environment, the impact of

[1] Climate change mitigation, climate change adaptation, sustainable use and protection of water and marine resources, transition to a circular economy, pollution prevention and control, and protection and restoration of biodiversity and ecosystems.
[2] EU's Non-financial Reporting Directive, which aims towards greater business transparency and accountability on social and environmental issues.

"green labels" on lending costs will likely be modest. Nevertheless, green labels could also have an impact on firms' stock prices, as investors place more and more demands on sustainability. The effects on funding costs will likely become more important in the longer term. However, firms need to start with sustainability strategies now, as it will make them more credible to investors and gives them more time to adjust.

The effects of the taxonomy on green bond issuance are harder to predict. While green bond issuance in Europe increased to a record level in 2020, the EU taxonomy could make it less necessary to issue green bonds, as companies with high level of taxonomy-aligned activities can get a "green bonus" even without them. On the other hand, the increased transparency brought by the taxonomy supports investor confidence in green bonds. In the future, the taxonomy-aligned bonds and other green bond frameworks such as the ICMA-framework will probably coexist and cover different activities.

Turning to the potential impacts on greenwashing, the EU taxonomy will likely succeed in reducing greenwashing, by providing clear definitions on sustainable activities. However, it should be ensured that the technical screening criteria are in fact science based. Furthermore, Europe's environmental footprint extends beyond own borders, which will limit the effects of the taxonomy. In addition to direct emissions, 25% of additional $CO2$ is estimated to be embedded in EU imports and international trade. Some economic activities are responsible for substantial indirect emissions far down their supply chains. The European commission has, however, taken first steps to a possible legislative initiative on mandatory supply chain due diligence that would also cover environment and human rights (European parliament, 2020.)

On top of the direct effects from the taxonomy regulation, the sustainability related disclosure regulation should have a greening effect on financial markets, as it increases transparency on financial firms' overall sustainability impact. Furthermore, as the regulation will likely speed up the dumping of fossil intensive investments and loans, it may also impact firms which are not active in financial markets.

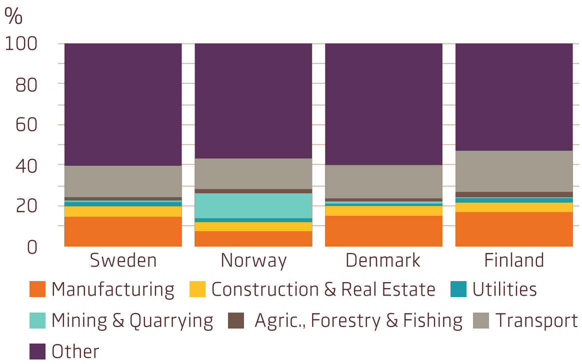
Effects in the Nordics: winners and losers

In the Nordic countries, green investment has already become an important trend: the issuance of sustainable debt, especially green bonds and sustainability-linked loans, has increased fast. The issuance of green bonds has also been high in a European comparison, especially in Sweden, where around 16 percent of corporate and government bond issuances last year were labelled as green according to Bloomberg data. The taxonomy will amplify the green trends and will likely help broaden them across sectors. The fact that many Nordic investors have sustainability-related targets or guidelines also means that the taxonomy should have a considerable impact.

Looking at the companies listed in the countries' main stock markets, a big share is in largely taxonomy-relevant sectors, especially industrials and, in Norway's case, energy. While the new regulations will affect an even broader set of firms, this indicates that many of the large Nordic businesses active in the financial markets will be affected. Data over value added also shows that these sectors are important to the Nordic economies, suggesting considerable potential economic effects from the regulations over time.

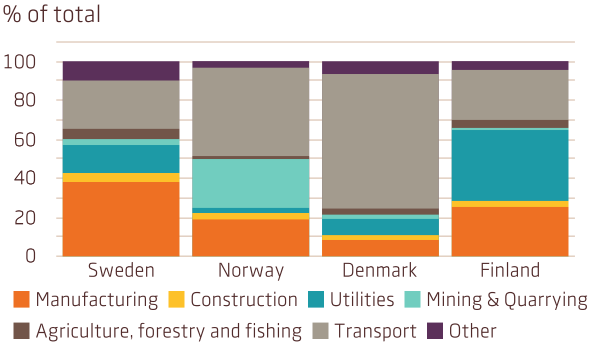
So far, many green bonds in the Nordics have been issued by firms in the real estate and power sector, while industrial sectors have issued far less green debt. However, construction and utilities only account for around 19% of Nordic countries' carbon emissions, according to Eurostat data. At the same time, manufacturing accounts for 38% of emissions in Sweden and 23% of overall emissions in the Nordics and meets big technological challenges for the transition. The criteria in the green taxonomy clarify how industrial businesses can reach taxonomy alignment and could therefore support their sustainability strategies and investments. There are also some transitional elements in the taxonomy, such as criteria that reflect the best practice performance in the sector and can be made more stringent in the future. Still, some fear that if investors disproportionately favor activities that can be labelled as green immediately, the taxonomy might be less effective in supporting the industrial transition.

Value added by sector



Sources: Swedbank Research & Macrobond

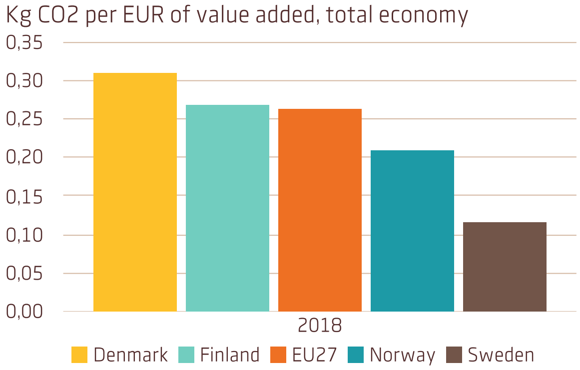
Carbon emissions by sector



Note: Data from 2018 for Norway, 2019 for other countries.
Sources: Eurostat, Swedbank Research & Macrobond

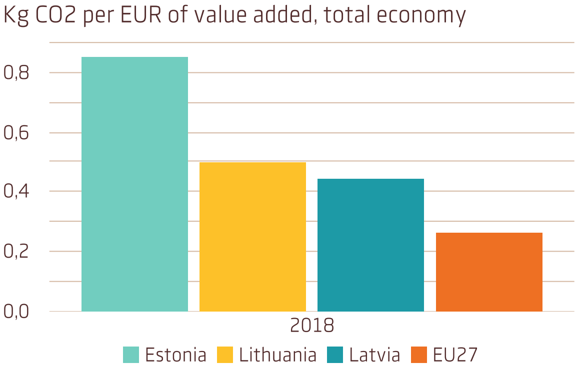
Many factors speak for the Nordics generally having good preconditions to gain from the green investment trends: apart for Norway, their manufacturing sectors have lower greenhouse gas emissions per unit of value added than the EU average. Sweden and Norway also have very low emissions from utilities, including electricity production. All the Nordic countries also rank highly in country comparisons on innovation (European Commission, 2020 & ITIF, 2019). Still, there will be losers as well. Some sectors may meet stricter requirements than before to claim a green label. The real estate sector has accounted for a large share of green issuance in Sweden, but the taxonomy draft includes stringent energy efficiency standards that could rule out projects eligible in earlier frameworks. Conventional forestry and hydropower will likely also lack taxonomy alignment, which has been feared to weaken the sectors' funding conditions.

Greenhous gas intensity: Nordics



Sources: Eurostat, Swedbank Research & Macrobond

Greenhous gas intensity: Baltics



Sources: Eurostat, Swedbank Research & Macrobond

Activities that are not taxonomy-aligned are not necessarily downright harmful, and the draft technical criteria can appear black and white when it comes to such areas. In the future, if a taxonomy defining environmentally harmful investments is implemented, this could bring more nuance in the classifications. It is also worth noting that only a relatively narrow set of activities will receive a green label in the near term, while investors will still consider all aspects affecting returns. Fears over financing conditions for non-taxonomy-aligned activities could therefore be exaggerated, at least in the near term.

Explicitly fossil-related activities are another matter. The fossil-heavy oil and shipping industries are important for the Norwegian economy. Firms in such sectors could meet higher funding costs relatively fast as investors move away from them, and the green taxonomy and the disclosure regulation will only strengthen these trends. Market trends away from such sectors could be further amplified if the EU also adds a taxonomy for environmentally harmful activities in the coming years.

Effects in the Baltics: long way to go

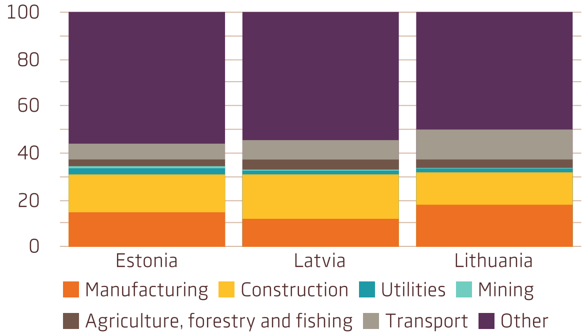
Unlike in the Nordics, green investment is only an emerging trend in the Baltics, and the pace is rather slow. Even though the issuances of green bonds have increased somewhat during the last few years, their slice of the pie is still too small to have a considerable impact.

When looking at gross inland energy consumption, it is clear **Latvia** and **Lithuania** enjoy lower CO2 emissions than Estonia only because both countries import large share of their energy. Thus, at the same time, exporting CO2 emissions. When compared to the rest of the EU, Baltic countries are also laggards when talking about the renewable energy share in gross final energy consumption. A large share of emissions is coming from the transport and manufacturing sectors as well, meaning the countries need large investments in order to reach carbon neutrality by 2050, as agreed in the Green Deal. In general, the utilities sector in Estonia and transport sectors in Latvia and Lithuania are the most CO2 intensive.

However, will taxonomy really be of any help? It seems the effects in the Baltics will be smaller than in the Nordics, at least in the short run. This is because Baltics have fewer large companies that are active in the financial markets, and hence will be less affected by the taxonomy directly. This can be illustrated by a small number of listed companies – 32 in Lithuania, 26 in Latvia and 21 in Estonia.

Value added by industry, 2019

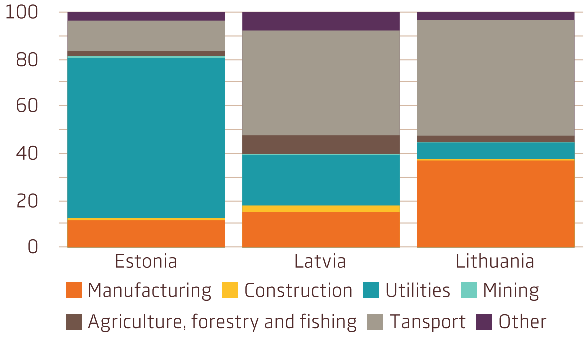
% of total



Sources: Swedbank Research & Macrobond

Carbon emissions by sector, 2019

% of total



Sources: Swedbank Research & Macrobond

Most of these listed companies are relatively important on regional level and can hence have an impact towards green investment in the long run. For example, Ignitis Group - the largest energy company in the Baltic States - is also the main energy provider in Lithuania. The green labels would provide an additional incentive for green investments, speeding up the transition towards renewable energy. However, only one energy company is listed on the Baltic stock exchange, illustrating that the taxonomy effects can be quite different for each Baltic state, depending on the sectoral composition of their largest companies. Moreover, if only a few companies are taxonomy-aligned, especially among industrials, we could end up with higher stock prices for a few selected firms, yet without a broader green transition.

Nevertheless, taxonomy will also force large unlisted companies active in the capital markets to report how much of their operations are taxonomy-aligned. As a result, the regulation might quite fast have an impact on large unlisted companies as well.

Despite their caveats, the green taxonomy and the disclosure regulation will likely be positive forces. For the Baltics, the taxonomy will be a turning point in defining what is green investment in general and will leave no space for interpretation. It also means Baltic companies will need to meet international criteria now and this could lead to more ambition over time.

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