CEPS COMMENTARY
Thinking ahead for Europe

China's ETS: A vote of confidence in carbon markets ahead of Paris

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The recent announcement by President Xi Jinping that China will start a national emissions trading scheme in 2017 can be seen as a genuine game changer. It has given a boost to carbon markets and cap-and-trade as the preferred way forward for those economies that have the capacity, the depth and the breadth for a liquid carbon market.

In addition, Mr Xi's announcement, made during his official state visit to the US in September, has the potential to alter the tone and substance of the discussions on competitiveness and carbon leakage. This is one of the top issues in the EU and the major component of the July 2015 legislative package published by the European Commission to operationalise the 2030 framework for climate and energy and the October 2014 EU Council Conclusions.

But what does it mean? According to the World Bank report "State and Trends of Carbon Market", about 23% of the world's GHG emissions are now under some type of carbon-pricing regime. China's announcement signals that the world's second-largest economy and the largest emitter has decided to put a price on GHG emissions through a cap-and-trade system.

This represents a significant vote of confidence in carbon markets as an approach towards curbing carbon emissions, which no amount of spin can undermine. Without a doubt, this will make carbon markets more appealing to China's major trading partners, as it creates a clear, and politically feasible path to a global carbon price in the future, and a more level playing field.

Objective observers will see that the EU has now been joined in its pioneering EU ETS by the world's largest emitter of greenhouse gases. In addition, the Republic of Korea has also recently started a cap-and-trade system, joining other jurisdictions, including the Regional Greenhouse Gas Initiative (covering the power sector in nine northeaster states of the US) and the California-Quebec link, soon to be joined by Ontario, the industrial heartland of Canada.

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At a recent press conference Japan's Environment Minister Yoshio Mochizuki said: "Emissions trading is a cost-effective measure that will certainly lead to emissions reductions. … We would like to consider the measure while looking at the impact on industry and employment." This statement may indicate that Japan, which has long been reluctant to adopt a cap-and-trade system, may be re-examining its options.

Although a US federal cap-and-trade seems not to be in the cards any time soon, remarks by New York Governor Andrew Cuomo in a speech at Columbia University on October 9th, suggests that there is some movement in this direction in the United States. Speaking alongside former US Vice President Al Gore, Cuomo said that combining the Regional Greenhouse Gas Initiative with the market used by California and the two Canadian provinces would accelerate efforts to reduce air pollution blamed for global warming. He also expressed the hope of involving other states and provinces with the goal of creating "a broader North American market to collectively reduce emissions".

The writing has been on the wall for some time, but especially since the UN Secretary General's Climate Summit last year in New York, when 73 countries and over 1,000 companies expressed support for putting a price on carbon. While there are always exceptions, most major economies and global companies have signed up, in part out of a recognition of the inevitability of carbon pricing.

Discussions of the various options available for carbon pricing have been going on for some time, and while choices depend on parameters referred to above, as well as political preferences, cap-and-trade provides the environmental certainty that is so much needed.

In the final analysis, this not about raising revenues, as badly needed as they may be by the public purse, but about environmental delivery. Other approaches may be portrayed as simpler, but politically they seem difficult. While taxes can be passed through, there is no hiding from the transparency and delivery of absolute emissions caps that carbon markets bring.

Action on climate change in many jurisdictions has been held back by the argument that carbon pricing in an asymmetrical global climate change regime may put certain economies and sectors at a competitive disadvantage and expose them to the risk of carbon leakage. It is no accident that the Clean Development Mechanism has been re-baptised by some as the "China Development Mechanism", and opposed on the ground that it is providing subsidies to Chinese competitors.

All US bills to address climate change have been criticised in the US for putting the US at a disadvantage with respect to Chinese competitors. With a cap-and-trade system in place in China in 2017, that argument is unlikely to hold much water in a rational discussion.

Inevitably, the focus will have to shift from national approaches to finding international cooperative approaches in order to address the issue of competition and carbon leakage.

Finally the Paris Agreement, which is still under negotiation, will attempt to provide a framework for creating an international carbon market. This will, in time, lead to one global carbon price, which is the ultimate aim of those who advocate market-driven change, rational economic asset allocation, flexibility and a move towards a more level playing field.

This will be achieved by unifying different emerging domestic carbon markets, through different routes, which may include linking, networking, clubs, as well as any other approaches that may emerge in time.

A global carbon tax may be tempting, and it may be simple, but it is not on the agenda at this time for the obvious reason that, especially before the Paris COP, it is politically explosive. One may also argue that it may neither be desirable nor needed. In time, a global carbon price will emerge bottom-up from the many domestic emissions-trading systems and prices that are currently operating, or being developed.

Cap-and-trade is still a young regulatory market, with many jurisdictions continuing to experiment and learn from each other. To the question "Is cap-and-trade a sound approach?", the Chinese have answered with a resounding YES.

To the question "Is the EU ETS as effective as we would want it to be right now?", the answer may be NO. However, such an answer does not recognise the complexity of the issues faced, is incomplete and may, inadvertently, give the impression that the approach itself is flawed. Instead, it should include the qualifying remark "but changes have been introduced that will address the issues".

Finally, carbon markets will not provide a panacea for curbing greenhouse gas emissions. No one is disputing that they need to be accompanied by other policies.

But that does not detract from the huge vote of confidence that carbon markets have recently received from China.