INSTITUTE FOR AGRICULTURE AND TRADE POLICY
COMMENTARY

Carbon markets:

A reliable and practical source of climate finance?

REMARKS OF JIM HARKNESS, PRESIDENT, IATP UNITED NATIONS FRAMEWORK CONVENTION ON CLIMATE CHANGE, TIANJIN, CHINA

About Jim Harkness

Jim Harkness joined IATP as president in July 2006. Previously he served as Executive Director of the World Wildlife Fund in China from 1999–2005. He has written and spoken frequently on China and sustainable development, and has served as an adviser for the World Bank and the United Nations Food and Agriculture Organization.

About IATP

Institute for Agriculture and Trade Policy works locally and globally at the intersection of policy and practice to ensure fair and sustainable food, farm and trade systems. IATP is headquartered in Minneapolis, Minnesota with offices in Washington D.C. and Geneva.

TIANJIN, OCTOBER 5, 2010 — Thank you for joining us today. My name is Jim Harkness. I am the President of the Institute for Agriculture and Trade Policy. We are a 25-year-old organization that works locally and globally to ensure fair and sustainable food, farm and trade systems. We are based in the United States, with offices in Geneva, Switzerland. And we have representatives on our board of directors from Brazil, the Philippines, Mexico, Canada and the Netherlands.

We're here to talk about financing for adapting and mitigating climate change. Most of us believe that we will not have a meaningful climate deal without a clear system of finance in place to invest in a low-carbon economy and adaptation. We are at a critical juncture in this discussion. As you know, a draft decision on a climate finance fund is expected in Tianjin. Also, the Secretary-General's High-level Advisory Group on Climate Change Financing (AGF), which was formed after Copenhagen, will be presenting a draft report on climate finance shortly after Tianjin and a final report before Cancun.

Much of the discussion in Copenhagen, and throughout the climate debate, has focused on carbon markets as a primary source of climate finance. Of the $100 billion a year by 2020 committed to "be mobilized" by developed countries within the Copenhagen Accord, much of that climate finance is expected to come from carbon markets. Many have argued that carbon markets are necessary because developed countries no longer have the public resources for climate finance. It's important to note that one reason developed countries are facing such financial constraints is the recent bailout of the financial services industry following a decade of its deregulation and spectacular near-collapse. We are deeply concerned that the global community is now being asked to trust this failed and unrepentant industry—which has fought regulation following its bailout—to provide adequate climate finance through carbon trading. We believe that carbon markets will not result in reliable and timely financing for the critical projects around the world that are needed to adapt to climate change and reduce greenhouse gas emissions. And, having studied the role of poorly regulated financial markets in the global food crisis of 2007-08, we are concerned that such markets will not only shift the burden of mitigation to developing countries, but will also adversely affect food security, and undermine many important efforts to deal with both climate change and rising global hunger.

Carbon and agriculture markets are tied together through futures markets. Big financial firms, many represented here in Tianjin, have positioned themselves to invest in carbon derivatives. These derivatives would be based on the value of carbon emissions permits—given to industry by governments—and of carbon offset credits. And these carbon derivatives could bundle together permits and credits with each other and with other commodities, such as oil or agricultural futures contracts.

Carbon derivatives would be created and traded under regulations that oversee all commodity futures contracts, which include agriculture, metals, energy and oil. And here's the crux of the problem. These commodity futures markets have experienced a decade of regulatory exemptions, exclusions and waivers that have led to excessive speculation by big Wall Street players. The result has been enormous price volatility and harm to many around the world.

Excessive speculation by big financial firms, like Goldman Sachs, on commodity futures exchanges are now well recognized as major contributors to the global food crisis of 2007-08. The U.N. Commission on Trade and Development (UNCTAD), a recent FAO committee report on agriculture price volatility and the U.N. special rapporteur on the right to food have all stressed the need to address excess speculation on these markets by big financial firms.

How do these firms distort futures markets and what exactly are the effects? The big financial firms use two key tools to game the system. One, commodity index funds bundle together up to 24 futures contracts for all types of commodities. So, within one fund you might have derivatives for corn, gold and oil all together. Because financial firms, unlike commodity users, are not limited in the number of contracts they can hold, financial speculator "weight of money" (the sheer size of their holdings) drives the prices of the indexed contracts. As these contracts are sold and new contracts are bought, the "weight of money" induces enormous price volatility, far beyond what can be explained by commodities supply and demand. This price volatility is also replicated in global food prices—this is devastating for poor consumers and for the small farmers who produce most of the world's food.

Carbon derivatives could also be bundled within a commodity index fund. The price effect of bundling contracts of consumable commodities and those of carbon, a wholly artificial and legislated commodity, can be difficult to predict. Legislation that allows the unlimited "banking" of carbon emissions permits could result in a periodic flooding of the market with permits. The resulting price drop would undermine the environmental objective of raising carbon prices to induce long-term industry investments in clean technologies. The current practice of trading carbon offset derivatives before the offset projects are verified to have reduced greenhouse gases could likewise result in price volatility, if the carbon asset underlying the derivative turns out to be fraudulent.

What would happen to agricultural contracts tied directly or indirectly to the vastly capitalized $2 trillion carbon market of 2017 forecast by the U.S. Commodity Futures Trading Commission (CFTC) under a mandatory U.S. carbon market scenario? The mostly likely outcome is that the bigger market drives prices in the much smaller agricultural markets. If agricultural futures prices return to their 2007-08 volatility, net import food–dependent developing countries would be unable again to forward contract food grains at reliable prices, leading to increased food insecurity.

A second way speculators take advantage of exemptions from commodity futures market rules is through over-the-counter (OTC) trading. These are unregulated private trades between firms, rather than trading on public and regulated exchanges. By trading over the counter, these financial firms are able to avoid regulatory scrutiny since OTC trade data are not reported daily to regulators, as is required of regulated exchanges. By claiming that OTC trades are "customized" and that the data is confidential business information, OTC traders gain an unfair price information advantage over public exchange traders

OTC trading is already common on the European Emissions Trading Scheme—accounting for 44 percent of all carbon trades in 2008, according to Point Carbon. Trading under the ETS has resulted in high volatility and low carbon prices. Low and volatile prices have not has spurred big emitters to invest in greenhouse gas–reducing technologies and practices, as required by the ETS legislation.

UNFCCC Parties will be asked to consider adopting another variant on carbon trading as a major source of climate finance currently pushed by one of the largest carbon trading lobbies. The International Emissions Trading Association (IETA) is made up of over 170 financial, law, energy and manufacturing companies. They are leading advocates for carbon derivatives. Their most recent proposal for financing is something called green bonds. We believe green bonds are also extremely vulnerable to excessive speculation.

Under the IETA proposal, financial firms would loan developing countries money—through a green bond—to engage in a carbon-reduction project. The carbon credit that would result from that project would serve as the collateral for the bond. IETA proposes that international financial institutions guarantee project loans in case of a developing country default.

Once again, if a carbon market is highly volatile, the developing country may not be able to cover that loan through the sale of carbon offset credits or other revenues. So, we have a scheme that puts developing countries into debt while guaranteeing the investment of financial firms. All under the guise of addressing climate change.

On the issue of climate finance, we need to start a new conversation and be open to new proposals and ideas. We need to answer such questions as: Who should provide the financing to address climate change? Who oversees that money and decides how it is spent?

We believe that those who are largest polluters historically have a responsibility to be the largest source of climate finance in accordance with the convention—and not just countries, but polluting industries as well. There are a variety of taxes being discussed including carbon, transportation and financial taxes. Those should all be on the negotiators' table.

It is absolutely essential that climate finance investments do not undermine food security, e.g., by displacing farmers from their land. Our goals should be exactly the opposite: to support sustainable agriculture that improves our ability to adapt to climate change, reduces greenhouse gas emissions, increases food security and strengthens rural livelihoods.

We strongly oppose the World Bank's involvement in controlling a climate finance fund. This proposal would divorce climate finance from the normative and technical agreements of the UNFCCC—a grave mistake. The World Bank has an unfortunate history in its involvement with the Clean Development Mechanism and other climate related projects—as well as being a leader in pushing for deregulation in the finance sector.

Instead, we believe the Adaptation Fund, within the UNFCCC'S Kyoto protocol, is the appropriate place for climate finance funds to be held and distributed. We also support the establishment of a new fund under the convention, as proposed by developing countries.

We are interested in working with others to develop new, creative ideas on climate finance. We believe that new approaches to climate finance will only succeed in addressing climate change if they are consistent with the convention and are transparent, inclusive and equitable.

We have materials on the table that go into more depth on the issues I've discussed today. You can find all of our materials on our website: www.iatp.org. Thank you!