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ESG special: EU green transition

Ending reliance on Russian energy will not come without short-term pain

- **The need to reduce reliance on Russian energy adds to the sense of urgency in Europe to accelerate the green transition. The new EU Commission plan calls for EUR 300bn of investments into energy efficiency, diversification of energy supplies and accelerated rollout of renewable energy by 2030.**
- **Green transition has the potential to boost innovations and productivity, and investments in green transition should support growth going forward. Efforts to improve energy self-sufficiency could buffer economies also in a scenario where a new cold war and loss of confidence would otherwise hamper economic activity.**
- **Inflationary impacts from green transition are ambiguous. While green energy is more affordable in the long run than fossil energy, potential supply-demand mismatches in raw material markets could, at times, contribute to volatility in headline inflation.**

The war in Ukraine is speeding up the European green transition. Russia supplies approximately 40% of the EU's gas and 27% of its imported oil. Massive investments in green transition were already in the pipeline before Russia started its war on Ukraine, and in late May, **the EU commission announced a *REPowerEU plan* where it intends to mobilize up to EUR300 billion by 2030 for the EU to become independent of Russian energy imports**. The measures will focus on 1) energy efficiency, 2) diversification of energy supplies, and 3) accelerated roll-out of renewable energy to replace fossil fuels in homes, industry and power generation.

The EU plan consists of approximately EUR72 bn in grants and EUR225 bn in loans targeting up to EUR10 bn investments into gas infrastructure, up to EUR2 bn investments into oil infrastructure with a view to stopping the shipment of Russian oil. According to Commission President von der Leyen, all the rest of the financing will go into speeding and scaling up clean energy.

A complete transformation of an energy system can typically take decades, as there is a multi-year lag between an investment decision and having new capacity in use. Hence, energy savings are the fastest and most affordable way to tackle the current energy crisis. In the new EU plan, the bloc's energy efficiency target for 2030 will be increased from 9% to 13%, and the 2030 target for EU renewable energy from 40% to 45%. In this context, *the Commission also recommends* behavioural changes for citizens in member states and encourages fiscal measures such as reduced VAT rates to promote the deployment of energy efficient solutions. Reducing heating temperatures at home, driving more economically and shifting to more public transport, using household appliances and air-conditioning more efficiently and switching off the lights can deliver substantial, short-term savings. According to IEA, such measures could cut oil and gas demand by 5% over a year.

The new EU plan to reduce reliance on Russian energy

- EUR 300bn invested in energy efficiency, diversification of energy supplies and renewable energy by 2030.
- Energy system transformations take time, and during transition period, the easiest and most low-cost way to tackle the ongoing energy crisis is by improving energy efficiency.
- Russia has already cut off gas deliveries to some EU countries and more disruptions are expected. The EU is looking for alternative sources but, towards next winter, gas prices are likely to remain elevated and volatile.
- Supportive policies will ensure a favourable environment for green investments going forward. Businesses enabling the transition and providing the right solutions are likely to benefit from sustained capital inflows.

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The second part of the new EU plan focuses on diversifying energy supplies. There is a plan to cut demand for Russian gas by two-thirds by the end of 2022. Russia has already cut off gas supplies to some EU member states, such as Poland, Bulgaria and Finland and more disruptions are likely. During the last months, the EU has managed to secure record levels of LNG imports and higher pipeline deliveries to compensate for the lower imports from Russia. Going forward, the EU will develop a joint purchasing mechanism to negotiate and contract gas and renewable hydrogen purchases on behalf of participating member states. While we think joint efforts are helpful at best, they are also voluntary, and hence, may not prevent a scenario where EU countries end up competing against each other in tight markets, leading to increased price volatility and higher prices.

The third part of the new EU plan calls for a massive scaling-up and speeding-up of renewable energy in power generation, industry, buildings and transport. The Commission proposes to increase the headline 2030 target for renewables from 40% to 45%. The plan includes doubling of solar photovoltaic capacity by 2025 and a Solar Rooftop Initiative with a phased-in legal obligation for solar panel installations on new buildings. The plan also entails doubling the rate of deployment of heat pumps, tackling the slow and complex permitting processes of renewable projects and a target of 10 million tonnes of domestic hydrogen production to replace fossil fuels, and decarbonise industries and transport sectors.

Looking at the current plans across major EU economies and the Nordics, the investment pipeline includes projects targeting renewable energy infrastructure, energy storing and electrification of industries and transportation. The current political support should ensure a favourable environment for such investments going forward amid accelerated planning processes, and capital inflows and investments are expected to benefit businesses that enable such technologies and solutions over the next few years.

In the coming years, green transition could fuel more persistent price pressures, or at least, contribute to more volatility in headline inflation. *The IEA has estimated* that sustainable development scenarios imply a scale of demand growth for metals and minerals well above the levels seen in recent decades. Electrification will require large amounts of industrial metals such as nickel and cobalt, whose average demand growth is expected two and five times higher in the period to 2040 compared to levels seen in 2010. And while clean energy is cheaper than fossil energy in the long run, increased volatility in metal prices as a result from supply-demand mismatches could, at times, contribute to upwards inflation pressures (read more in *Research Euro Area - Europe's green transition: the heat is on for euro inflation*, 16 September 2021).

Over time, green investments support growth and could buffer economies in case we end up in a new 'cold war' period where a collapse in confidence hampers private investments and consumption, as focus on energy self-sufficiency is likely to dominate even in such a negative scenario. In the best case, focus on green innovations and new technologies will boost productivity, raising the potential of an economy longer term.

However, in the short run, we see the ongoing energy crisis and the cut-off from Russian energy posing more downside than upside risks to growth in Europe. While consumption will take a hit from the elevated energy prices and the erosion of real income, the impact on European industries from a complete cut-off from Russian gas would be devastating at worst. Petro-chemical industry is the most vulnerable, and several industries that use raw materials produced from hydrocarbon molecules, such as agriculture and food, cosmetics, pharmaceuticals, automotive, construction, packaging and electronics would ultimately be affected. Europe can, and eventually will, end its reliance from Russian energy but the short-term energy and material transition will not be without pain.

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