

# Inflation, innovation and the carbon market

An investment in carbon assets doesn't just confer the right to emit greenhouse gases – it also offers potential hedges against inflation and the failure of technological innovation, says

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**D**espite the recent government bail-outs, bank 'stress tests' and economic rescue packages, there is little doubt that the world's financial markets will still be in a considerable state of disarray for some time to come. Of all the macroeconomic stabilising mechanisms employed by governments, policy-makers and central banks, none has been more consistently used in recent times than controlling the supply of money through interest rate adjustments.

As the most recent economic crises unravelled, nearly every country in the world cut its base cost of borrowing to lenders and increased its own borrowings at the same time. The hope is that, at some point, lenders, banks and investors that are not satisfied with these low returns will eventually start to lend money towards, or invest in, instruments and opportunities that have potentially more risk, and correspondingly higher expected returns.

When this point comes, given all the money that may have been pumped into the system by that time, the world could potentially experience a massive inflationary cycle. In economic terms, this would result in a 'demand-pull inflation scenario', whereby price levels rise because aggregate demand outstrips supply. In other words, there would be too much money chasing too few goods. So what does all this have to do with climate change and, more specifically, investments in carbon and environmental markets?

**A** carbon credit, either in the form of a compliance allowance or a carbon offset, is an energy commodity that is linked to the price of natural resources and fossil fuels. It is a financial instrument that represents the cost of reducing, avoiding or sequestering greenhouse gas (GHG) emissions, thereby allowing the owner of a credit to produce a marginal unit of energy generation (or another commodity involving GHG emissions). Because of its unique properties, exposure to the price of carbon is a natural hedge against inflation, as well as against a failure of the innovation that will be necessary to abate climate change.

In a cap-and-trade system, one of two basic activities occur at regulated entities: polluters reduce their emissions via a combination of innovation, efficiency and/or demand reduction; or they purchase carbon credits to offset their emissions. The price of carbon is highly correlated with those of fossil fuels and their interrelationships as carbon represents the cost of abating emissions from these sources of energy.

As the effective prices of these fuels increase, they will become the 'expensive' alternatives to new sources of renewable

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energy, where there are no penalties on consumption. Their prices will rise, along with the price of carbon, which will also increase over time as emissions caps become more stringent and the corresponding penalty for emissions becomes more expensive.

In addition to increasing money supply, another potential cause of inflation, generally, is taxation. And, under an auction scenario, whereby emitters are forced to buy the allowances they need rather than receive them for free, a cap-and-trade system looks very much like a tax – at least from the perspective of a regulated entity. In any industry, regulated or unregulated, as a company's costs go up due to increased taxes or cost of regulation, it needs to increase prices to maintain margin. It is common practice for businesses to attempt to pass these burdens on to their customers.

In addition to many examples in other industries, such as tobacco and telecoms, this pass-through concept has been observed in

the EU Emissions Trading Scheme, where consumers have absorbed the bulk of the cost of the system, which was passed through to the cost of power. If the US decides to auction all or part of its allowance allocation, as has been suggested by President Barack Obama, the cost of compliance is likely to be passed on to consumers as well. Exposure to the price of carbon would be a hedge against this price inflation as the cost of the increase would be correlated with the price of carbon itself.

**C**arbon is not only a hedge against inflation but, in a cap-and-trade system, it can also be seen as a hedge against a failure of innovation. As a society, the less we're able to innovate and devise and implement new technologies that curb fossil fuel emissions, the higher the cost of fossil fuel-derived energy will be. This will occur not only through systematic depletion of these resources but also because a cap-and-trade system will penalise the consumption of these types of energy. The price of carbon, in effect, will represent this price tag as the regulatory cap tightens over time. Exposure to the price of carbon will hedge this risk.

Therefore, in addition to the myriad commercial and environmental benefits of investing in carbon, a smart investor can use the carbon markets to hedge certain forms of inflation risk, as well as risks associated with climate change innovation. 

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