Climate change is becoming a game changer for government debt

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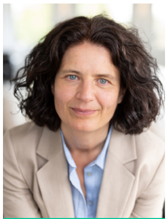
As governments continue to raise their debt ceilings, it becomes crucial for us to adapt to this new normal.

Most recently, the United States found itself in this position. But what factors contribute to the rising costs? And how should we evaluate a government's creditworthiness?

Experts



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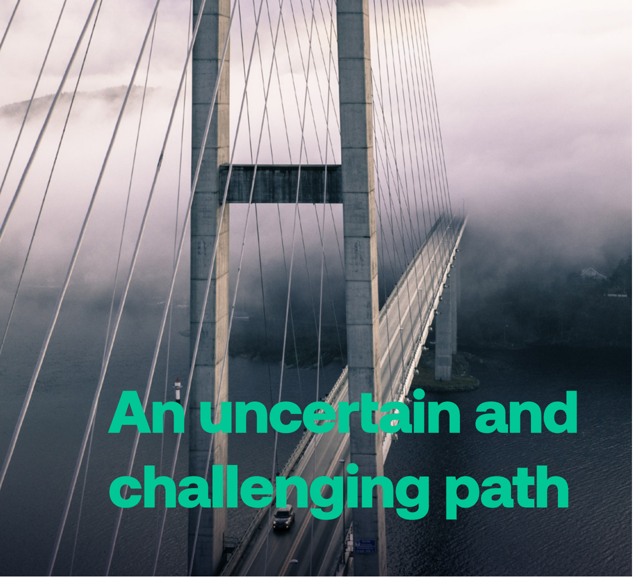
Undoubtedly, climate change is exerting a significant influence on government budgets and debt levels. The controversy surrounding the United States' debt ceiling may appear as a recurring disagreement ingrained in American political traditions. The debt ceiling, established under U.S. law during World War I, mandates that the government must seek Congress' approval periodically to increase borrowing when the national debt reaches a predetermined limit. Historically, raising the debt ceiling has often involved negotiations between the White House and Congress. Fortunately, the threat of a government shutdown, resulting in closures and delayed payment of salaries to employees, has been averted. Temporarily setting aside their differences, Democrats and Republicans have ensured that the government can fulfill its financial obligations once again.

Climate change as a transformative force

However, the current situation holds higher stakes. The underlying cause of the tensions between Democrats and Republicans is the implementation of a stimulus program known as the Inflation Reduction Act. This program not only provides American companies with substantial access to government subsidies, amounting to billions of dollars, to support sustainability initiatives but also aims to enhance social conditions. At one point, there was a genuine concern that the United States might face another downgrade in its triple-A credit rating. The possibility of the U.S. failing to fulfill its financial commitments prompted a credit rating agency to place the rating of U.S. debt under negative watch.

The trend of governments struggling to manage their budgets is not a recent phenomenon. In recent years, we have witnessed a consistent growth in government debts, often attributed to a combination of increasing government spending and tax cuts. The financial crisis of 2008 and the COVID-19 pandemic in 2020 have further exacerbated this situation. However, the emergence of climate change as a significant factor is poised to revolutionize government debt levels.

Climate change introduces a range of physical risks that governments must contend with, including the likes of droughts, wildfires, and floods. Even a few days of heavy rain in 2021 led to severe consequences, such as 45,000 flooded houses and the displacement of 100,000 citizens in Wallonia. These events exerted a destructive impact on Wallonia's budget, resulting in a substantial seven percent increase in the region's overall debt.



An uncertain and challenging path

Transition entails an unpredictable journey

The transition to a more sustainable society presents an uncertain and challenging path. Without proactive government intervention to adapt the economy, there are inherent risks for sectors that may become obsolete. Failing to phase out specific industries in a timely manner and replace them with sustainable alternatives can exert significant pressure on a country's gross domestic product (GDP). Furthermore, when the government mandates the closure of factories or industries, affected companies often seek compensation, creating additional financial burdens on the government.

Another crucial aspect to consider is the impact on employment. When industries undergo significant changes or closures, there is a substantial cost associated with job losses.

Additionally, the transition to a sustainable society can give rise to social unrest. The yellow vests movement in France serves as a striking example of the instability that can arise when the burden of change falls on certain segments of society. When people do not directly witness the immediate consequences of climate change in their surroundings, their motivation to contribute financially towards addressing the issue may be diminished. Unfortunately, low-income individuals often bear the brunt of these changes.

Assessed from an ESG standpoint

In the coming years, governments will face the imperative to make substantial financial investments. These investments are necessary to support the transition towards a more sustainable future. Governments must allocate funds to provide subsidies that stimulate and initiate crucial changes in various sectors.

Subsidies, along with strategic tax cuts, play a pivotal role in encouraging both consumers and businesses to adopt less polluting technologies and practices. By providing these incentives, governments can drive innovation and promote the widespread adoption of sustainable solutions.

A noteworthy example of such commitment is the European Commission's proposal of the Green Deal Industrial Plan in February of this year. This ambitious plan aims to support and accelerate the greening of the European industry. It comes with a significant multi-billion-dollar budget

Assessing the creditworthiness of a country through an ESG lens is becoming increasingly valuable. It allows us to gauge how effectively the country manages its environment, society, and governance. This holistic approach is akin to a BMI score that reveals an individual's fitness to tackle various challenges. Strong and well-functioning government institutions play a vital role in reducing the likelihood of corruption or undemocratic practices. Respect for human rights is another crucial aspect to consider. When extreme poverty, inequality, lack of education, or inadequate healthcare prevail, they can give rise to social unrest, which ultimately impedes a country's overall functioning.

Furthermore, the proper management of the environment and natural resources holds great significance. Biodiversity serves as the foundation for a thriving ecosystem, and neglecting its preservation can have far-reaching consequences. An unhealthy and polluted environment not only adversely affects our well-being but also carries economic implications.

An additional tool to mitigate risks

The costs associated with the sustainability transition loom as a massive mountain, its full extent still concealed from view. Presently, credit rating agencies do not perceive this impending cost burden as a reason to adjust ratings. Those countries boasting high per capita income, robust economic growth, and diversification are likely to receive favorable grades. However, investors are increasingly attuned to the risks surrounding the sustainability transition.

The mounting government debt is a prevailing trend exerting upward pressure on interest rates. Moreover, physical risks, such as breaches in dikes, can disproportionately impact countries due to the temporary shutdown of businesses, resulting in inflationary effects. Consequently, nations grappling with significant physical risks are already witnessing an increase in the risk premium of long-term bonds. This underscores the importance of a meticulous evaluation of countries, with heightened attention given to ESG factors and the mitigation of associated risks. These considerations should inform strategic asset allocation and long-term returns.

For investors, assessing a country's performance based on ESG efforts - encompassing environmental, social, and governance aspects - serves as an additional tool to mitigate risks effectively. By taking into account these critical factors, investors can better navigate the evolving landscape and make informed decisions that align with sustainable practices.