Q&A-Soft commodity market “largest game in town” in nature finance; mitigating climate impacts vital: Simon Zadek, NatureFinance

Increasing transparency and integrating nature and climate factors into the regulation of soft commodity markets is vital in the process of expanding nature markets, **Simon Zadek, executive director of NatureFinance** told the Reuters Global Markets Forum on Friday, September 22.

“Nature markets are emerging in all sorts of different places, without a doubt soft commodity markets are the largest game in town,” Zadek said.

“There is extreme concentration in multiple directions as well as an extraordinary lack of transparency.”

Zadek added that central banks and regulators integrating nature concerns into risk assessments was vital, but policies must include measures to mitigate the impacts on agricultural prices and livelihoods.

Following are edited excerpts from the conversation:

Q: Of the several recommendations made by the TNM (Taskforce on Nature Markets) report, which would take priority for you in terms of implementation?

A: The macroeconomic dimensions, the geopolitics plus the impact of climate on fragmentation itself - all three of those drivers challenge us to deliver on our primary climate targets. Notwithstanding the need to intensify efforts, we need to actively plan for a world of higher temperatures and more volatility and associated catastrophes. I think the news is not good. The predictions are not good, but the consequences need to be understood. But it isn't a question of despair. It's a question of continuing to double down, but to also begin to think about and act around some of the changes that are needed if we are not going to meet those targets.

The top two recommendations concern the international financial and economic architecture within which nature markets emerge, and the roles and mandates of central banks and financial supervisors. These are the most important macro framework drivers without which some of the more micro or bottom up changes that are implicit in other recommendations will be very hard to sustain. For example, if trade policy begins to discriminate against nature rich economies that are struggling to manage deforestation, in part because they house agribusinesses that are exporting to the very countries that are imposing trade restrictions, it's unlikely that we're going to make much progress. So that would be part of the answer.

I would just say, although nature is everywhere and nature markets are emerging in all sorts of different places, without a doubt soft commodity markets are the largest game in town.

Q: On that last one - what are some ways to implement more sustainable changes in the commodity markets in a way that keeps prices at sustainable levels?

A: When it comes to the core of food commodity markets, as you know, there are a very small number of players, none of which are publicly listed. It's highly integrated vertically and horizontally. So in effect, there is extreme concentration in multiple directions as well as an extraordinary lack of transparency. That's without talking about nature and climate. So actually the first set of things one would put on the table is you can't run a global market like this anymore. This is not the nineteenth century. We need a set of markets that are systemically important to be more transparent, less monopolized, potentially to have less vertical integration. That's before you get to nature, climate or equity. These are very basic rules of how to build markets effectively. I'm an economist by training, so I would say this about multiple markets, but this one in particular.

If we have 130 central banks and financial regulators that are beginning to integrate climate and nature into their jobs, which is what we have through the network for greening the financial system, how is it that we don't have commodity regulators doing the same thing? There's no logic to it at all. If anything, commodity regulators should be in advance of central banks and financial regulators in integrating nature and climate considerations. In its very simplest form, at a risk level, which means at a transparency level, even before you get to them potentially adopting normative goals that are in effect being adopted by their policy colleagues and governments.

On your other question on the costs, a year and half ago we did a piece of simulation work to look at the impact of integrating nature related risk into financial markets on food, asset valuation and the flow through to employment effects and the cost of nutrition. What we were trying to show is that if you front end the integration of nature related risk without compensating policies in the real economy, it can have significant impacts on production and employment, particularly in areas that are nature fragile, which are places where often many, many small holders are working. It can certainly impact the cost of nutrition because it increases the cost of production. What our simulation tells us is as nature begins to become integrated both into financial considerations and for example, commodity markets, there will be impacts on the normative plays, nature, climate and that affects employment effect and cost of nutrition effect. So, we need to build compensating policy architecture. If we don't, of course governments will resist change because they don't want to see significant unemployment fallouts from integrating nature related risk into financial decisions, in order to protect livelihoods and food security.

Q: What are some of those policies that could be put in place?

A: So, are we talking about tens of millions of people in India? Or are we talking about small numbers of people in the Netherlands? Let's take the easy one first, the Netherlands. We've had the Supreme Court ruling which required the government to reduce carbon emissions much more quickly than they had planned. That led to their decision to reduce cattle farming in or livestock farming more broadly in the Netherlands. That led to a political party being created by the farming community to try and resist those changes, and that led to the Dutch government setting aside $28 billion to buy out 20% of the livestock farming community at 120% of asset value and then turning that land over to rewilding and float control. That illustrates, albeit at a very controlled level, exactly the dilemmas, particularly on the impacts on employment in the ag sector, less so on the impact on the cost of nutrition.

Of course when you move to a much larger system – Brazil, as an example -- we begin to see the growing impacts of Lula's efforts to reduce deforestation. Now, over the last six months, the data is that they have reduced the rate of deforestation by 46%, which is an extraordinary thing to do in such a short period of time. It shows you that actually it's not money in this case, it's political will and it has nothing to do with the financial sector at all, it had largely to do with military interventions. How does that affect food production and the cost of nutrition? Three days ago I was in New York sitting in a meeting with Minister Haddad, the Brazilian Minister of Finance. His answer to your question was we intend to double Brazilian food production with exactly the same amount of land. So what does that mean? Without diving into the details, that basically means technology and farming techniques. Now obviously in Brazil, we're talking about large scale agricultural business, not so much small farming systems that you would find in say India where implementing technology plays is a much more difficult thing to do. But Brazil, again, is a very real case in point. There new ecological transition plan just released under the authority of Minister Haddad, exactly points to this issue and says we will reduce deforestation to zero and we will maintain, if not increase the level of food production and exports out of Brazil. That's primarily meat, soy, and palm oil. We will do that on the same amount, if not less land than we are currently farming at. So that's all agricultural practices and technology. That's obviously a challenge in other countries, but it's very interesting to see your question being directly addressed in Minister Haddad's plan.

Q: Do you see increasing demand for nature and sustainability linked bonds?

A: Nature and climate linked sovereign debt will become increasingly important not through innovative financial mechanisms, but through the integration of nature risk into sovereign ratings, as we have seen over the last few years, is happening in the climate space. So that's not in the innovative instruments side, but that's pushing nature into sovereign credit analysis. Secondly, we will see a growth in the number of classical SLB's like Uruguay and Chile. But what's not clear is whether the step up or step down will be a significant incentive or not.

Then, the third part is in the context of 60 countries from the developing world having extreme debt distress. So what we've seen in Ecuador, Belize and Barbados for examples, that involves credit enhancement and creates a delta of up to 150 to 200 basis points in debt servicing costs. That it seems to me, with the debt crisis that we have, to have very significant growth potential but requires extended availability of credit enhancement from multilateral development banks and other public bodies.

Q: One of your recommendations was the integration of climate into central bank goals and mandates - how likely is that conversation to move forward given the Federal Reserve, for example, has already pushed back on that suggestion?

A: It's worth just reminding us how recent and how rapidly the central banking community has come on board and what an early stage we're at. Our observation is that integrating nature and climate into, for example, financial stability considerations, is simply not sufficient to get the job done, and that it's important that those that are governing the financial system step up their game. Then, the question becomes how? One version is to continue the game in play and to improve and enhance the modelling work in order to enable central banks to act more aggressively in implementing monetary policy and regulatory interventions within the mandate of financial stability.

The second model is to either shift the mandates or to successfully argue that central banks and financial regulators, most of whom are public bodies, should be aligning the practices to policy decisions made by their governments. If we have not just a policy, but a legally binding requirement made by a government, then how is it possible that one has a public institution like the Bank of England that is not ensuring that its financial actors are not aligning themselves to that policy outcome? So our argument would be shifting policy mandates is not needed. What's needed is policy alignment. Is that going to be hard to do well?

We have precedence for that. We could argue that during the pandemic and quantitative easing, effectively you had a monetary policy that was printing money in order to be able to enable the government to expand their fiscal envelope, to pay subsidies in the context of the pandemic. Is that really OK within the existing mandates? Pretty dodgy as we now see as inflation begins to go up. So central bank independence and narrow mandates don't always play out in practice, and we need to understand that. My prediction is that if that policy alignment doesn't emerge organically, then just as governments and companies have found themselves in court, so will central banks and financial regulators.

Q: I'm sure there will be a lot of debate on that for a while!

A: I think we will see a next generation of litigation that will challenge those institutions for not aligning themselves to climate in particular, but also nature policy objectives and legal structures that already exist within which the country inside the countries in which they're domiciled.