Istituto Affari Internazionali

Financing the Transition in Germany and Italy amidst Market Instability

by Alessio Sangiorgio

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The cost of transitioning economies towards net-zero will be immense. According to the Commission, the European Union will need around 620 billion euros annually,[1] with Italy and Germany requiring respectively up to 3.5 and 2.3 trillion euros in additional investment by 2050 to reach their climate targets.[2] Since the 2015 Paris Agreement, attention to the financial aspects of the transition has grown both at European and national levels.

In parallel, the private financial sector has also committed to decarbonisation, with the largest Italian and German banks and insurance companies, like Intesa SanPaolo, UniCredit, Generali, Commerzbank and Deutsche Bank, becoming members of the Glasgow Financial Alliance for Net Zero, pledging to align their operations with carbon neutrality.[3] The private financial

[1] European Commission, *Questions and Answers on the Sustainable Finance Package*, 13 June 2023, https://ec.europa.eu/commission/presscorner/detail/en/qanda_23_3194.

[2] "Quanto ci costerà la transizione verso un mondo a emissioni zero? Spoiler: molto più del previsto", in *Il Sole 24 Ore*, 11 February 2022, https://www.infodata.ilsole24ore.com/2022/02/11/quanto-ci-costera-la-transizione-verso-mondo-a-emissioni-zero-spoiler-molto-piu-del-previsto; Federal Association of German Industry (BDI), *Klimapfade für Deutschland*, 18 January 2018, https://bdi.eu/publikation/news/klimapfade-fuer-deutschland.

[3] Glasgow Financial Alliance for Net Zero (GFANZ), *2023 Progress Report*, December 2023,

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This commentary presents some of the key issues discussed during a workshop organised by IAI, which brought together financial sector representatives from both Germany and Italy. The event is part of a broader IAI project, "An Italian-German Dialogue on Energy Security and Transition amid Russia's War on Ukraine", supported by the German Federal Foreign Office.

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sector will be crucial to mobilise the necessary funds for the transition, and Italy and Germany should encourage collaboration between public and private financial actors, promoting guarantees and incentives for investing in green projects. At the same time, they should increase cooperation at the European and bilateral levels to increase market stability and develop common financing solutions.

Public finance in Germany and Italy

In the last years, Italy and Germany's finances have been burdened by several factors, from the economic slowdown caused by the pandemic and the energy crisis to the consequent increased spending on emergency measures to support households and businesses. Despite these events, national and European recovery plans have significantly boosted investment in green projects.[4] In Italy, 71.7 billion euros of the National Recovery and Resilience Plan (37.5 per cent of the total national fund) were allocated to green projects;[5] similarly, in Germany, 12.5 billion euros (42.7 per cent of the total national fund) were designated for the energy transition.[6] Furthermore, the EU allocated additional 20 billion euros in REPowerEU grants to support clean energy initiatives.[7] However, both governments may not be able to sustain these levels of funding in the long run without resorting to increasing debt. Furthermore, the time horizon of NextGenerationEU is approaching and there is uncertainty about the realisation of a similar tool for non-emergency times.

The 2023 German debt crisis further aggravated its public financial fatigue. The crisis began when the German Federal Constitutional Court found the proposed government's 60 billion euros climate fund in violation of the *Schuldenbremse*, the constitutional rule aimed at limiting deficit under 0.35 per cent of the GDP.[8] The Court's decision blocked the implementation of the fund, forcing the Government to revise its budget, downplaying the role of climate action investment.[9] The crisis arrived at a moment when German industries estimated the necessity of 213 billion euros in additional public investment over the next ten years for the energy-efficient modernisation of buildings, grid expansion for electricity, hydrogen infrastructures, and production and storage of renewable energies.[10] Similarly, Italy is

https://assets.bbhub.io/company/sites/63/2023/11/GFANZ-2023-Progress-Report.pdf.

[4] International Energy Agency (IEA), *World Energy Investment 2023*, May 2023, https://www.iea.org/reports/world-energy-investment-2023.

[5] Italian Government, *Recovery and Resilience Plan*, 12 January 2021, https://www.mef.gov.it/export/sites/MEF/en/focus/documents/PNRR-NEXT-GENERATION-ITALIA_ENG_09022021.pdf.

[6] German Federal Ministry of Finance, *German Recovery and Resilience Plan*, January 2021, https://www.bundesfinanzministerium.de/Content/EN/Standardartikel/Press_Room/Publications/Brochures/2021-01-13-german-recovery-and-resilience-plan.pdf.

[7] European Commission, *REPowerEU – 2 Years on*, 13 May 2024, https://energy.ec.europa.eu/node/5357_en.

[8] Shahin Vallée, "Germany Has Narrowly Swerved Budget Disaster – But Its Debt Taboo Still Threatens Europe", in *The Guardian*, 13 December 2023, https://www.theguardian.com/p/pfzhb.

[9] Ibid.

[10] Sebastian Dullien et al., "Herausforderungern für die Schuldenbremse. Investitionsbedarfe in der Infrastruktur und für die Transformation",

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experiencing some financial strain due to the slowdown in economic activities and the high cost of emergency measures implemented in recent years, as shown by the decision not to extend the tax cuts on fuels.[11] Italy has proven itself more fragile than Germany, with persistently low productivity growth and slow administrative procedures contributing to low investment attraction in all sectors.[12] In 2023, investment slowed down even further due to rising financing costs and the phasing out of the so-called *Superbonus* programme, the housing renovation tax credits.[13] The limits of public finance in both countries show the necessity to involve private financial actors to carry part of the cost of the energy transition.

Aligning climate objectives and profitability

Profitability remains the main indicator of the private financial sector's willingness to invest in sustainable projects. However, there are ways to sustain green projects while increasing returns. First, thanks to their proficiency in risk assessments and market trends predictions, commercial banks and investment funds may have an advantage in evaluating future demand for green sectors beforehand. This may help them identify opportunities that will be increasingly profitable in a future net-zero scenario. Similarly, they may be able to identify and provide loans to businesses developing sustainable technologies that are not particularly competitive in current markets but that are expected to thrive in a post-transition world. Insurance companies can also support the transition by addressing risks of climate-induced disasters, such as floods and drought damages, and limiting large-scale losses. Financial products, like green bonds, can also enable capital raising for sustainable projects while maintaining profitability.

In Italy and Germany, green bonds segments of the national stock exchanges have been extremely profitable, reaching total outstanding amounts of 261 billion euros in Germany and 161 billion euros in Italy, with insurance companies and commercial banks like Deutsche Hypothekenbank, Commerzbank and DZ Bank in Germany,[14] and Intesa SanPaolo and Unicredit in Italy being the largest private financial green bond issuers.[15] Green bonds have been

in *IW-Policy Papers*, No. 2/2024 (14 May 2024), p. 8-9, https://www.iwkoeln.de/en/studies/simon-gerards-iglesias-michael-huether-investment-needs-in-infrastructure-and-for-the-transformation.html.

[11] Italian Ministry of Economy and Finance, *Italy's Stability Programme 2023. Abridged Version*, 28 April 2023, p. 23-27, https://www.dt.mef.gov.it/en/attivita_istituzionali/analisi_programmazione_economico_finanziaria/documenti_programmatici/index.html?selezione-anno=2023.

[12] Banca d'Italia, *Financial Stability Report*, No. 1/2024 (April 2024), https://www.bancaditalia.it/pubblicazioni/rapporto-stabilita/index.html.

[13] Italian Ministry of Economy and Finance, *Italy's Stability Programme 2024. Abridged Version*, 9 April 2024, p. v-vii, https://www.dt.mef.gov.it/en/attivita_istituzionali/analisi_programmazione_economico_finanziaria/documenti_programmatici/index.html?selezione-anno=2024.

[14] Climate Bonds Initiative, *Germany: Green Finance State of the Market*, July 2019, https://www.climatebonds.net/node/38227.

[15] Danilo Liberati and Giuseppe Marinelli, "Everything You Always Wanted to Know about Green Bonds (But Were Afraid to Ask)",

an effective tool to finance adaptation strategies and preventive measures, like increasing food and water systems' resilience against climate-induced disasters, which generally attract less private funding.[16] Indeed, financial actors may benefit from promoting adaptation strategies in their portfolios, as they would be exposed to decreasing returns if they invest in or lend to companies with low resilience to climate-induced events.[17] The 2021 floods in Germany were estimated to have caused up to 44 billion euros of damages, while the losses related to the 2023 Italian floods were recorded to be around 40 billion euros.[18] In both cases, spillover losses from the real economy to financial markets have been difficult to quantify, but the disasters have halted planned investment, impacted investors' confidence to fund future projects in those areas, and even increased borrowing costs.[19]

Financial actors may address these situations by expanding their role as advisors, helping customers to develop adaptation plans. Allianz, for example, thanks to its propensity to assess scenarios, has established a service to advise customers on climate-related risks and to help them adapt their operations to climate change.[20] Unaddressed climate consequences may also increase insurance costs, leading to unaffordable premiums for some customers. If insurance markets become too expensive for customers and offering coverage becomes too risky for insurers, the entire sector could be paralysed. A solution could be to offer adaptation discounts for those customers who have spent part of their budget on building resilience. This would effectively lower risk-return calculations for insurers that would be able to lower prices.

Regulatory framework

Market disruption caused by Russia's invasion of Ukraine has lowered investors' confidence, as Germany and Italy were among the most vulnerable economies to natural gas shocks.

Additionally, persistent high interest rates in Europe have limited financial actors' capacity to invest in clean energy projects. Therefore, to promote private investments, there is a need for regulators to enact measures to

in *Questioni di Economia e Finanza*, No. 654 (November 2021), https://www.bancaditalia.it/pubblicazioni/qef/2021-0654/index.html.

[16] Ujala Qadir and Kamleshan Pillay, *Green Bonds for Climate Resilience. State of Play and Roadmap to Scale*, Rotterdam, Global Center on Adaptation, 2021, https://gca.org/?p=6754.

[17] Nicola Ranger, Olivier Mahul and Irene Monasterolo, *Assessing Financial Risks from Physical Climate Shocks: A Framework for Scenario Generation*, Washington, World Bank, 2022, p. 19, https://documents.worldbank.org/en/publication/documents-reports/documentdetail/760481644944260441.

[18] European Environment Agency (EEA), *Economic Losses from Weather- and Climate-related Extremes in Europe*, 6 October 2023, https://www.eea.europa.eu/en/analysis/indicators/economic-losses-from-climate-related.

[19] EEA, *European Climate Risk Assessment*, 2024, https://www.eea.europa.eu/publications/european-climate-risk-assessment.

[20] Kristin Stechemesser, Jan Endrikat and Edeltraud Guenther, "Insurance Companies' Responses to Climate Change: Adaptation, Dynamic Capabilities and Competitive Advantage", in *The Geneva Papers on Risk and Insurance - Issues and Practice*, Vol. 40, No. 4 (October 2015), p. 557-584, DOI 10.1057/gpp.2015.1.

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increase market stability and to derisk green projects.

Monetary policies are the main tool to channel private capital where it is needed. Following the energy crisis, the European Central Bank's actions to slow down inflation have had a particularly negative impact on the energy transition. While high borrowing costs are an obstacle for any investment, renewable projects are more capital-intensive and are therefore more susceptible to high interest rates.[21] While the ECB's recent interest rate cut may lead to some improvement in investments,[22] national action is still necessary. Banca d'Italia and Deutsche Bundesbank should increase their bilateral coordination through the alignment of their macroprudential measures and stronger information exchange, which might have a positive impact on building investors' confidence and increasing financial stability for companies that operate in both countries.[23]

Regulators may also attract capital by increasing clarity related to green projects. The main instrument to do so is the EU taxonomy for sustainable activities, which establishes a common framework to define sustainability for investors and companies. However, a possible reform could expand its classification to comprehend a "brown" taxonomy, which would define criteria to classify high-emissions activities as harmful to the environment. It could be instrumental in helping financial institutions in their assessment of the environmental impact of companies they are involved with.[24]

A sustainability reference framework should also be applied to private green bond issuance. Indeed, while most green bonds in Italy and Germany have been issued by public development or central banks, there has been a rising tendency for private companies to develop their own fixed-income instruments promoting the development of environmental projects.[25] Currently, both Borsa Italiana and Börse Frankfurt, respectively the two countries' largest stock exchanges, bundle in their green segments exclusively bonds that meet the voluntary guidelines of the International Capital Markets Association (ICMA).[26] Linking private

[21] Peter Martin et al., "Conflicts of Interest: The Cost of Investing in the Energy Transition in a High Interest-rate Era", in *Wood Mackenzie Horizons*, April 2024, p. 2, https://www.woodmac.com/horizons/energy-transition-investing-in-a-high-interest-rate-era.

[22] Martin Arnold, "European Central Bank Cuts Interest Rates for First Time in 5 Years", in *Financial Times*, 6 June 2024, https://www.ft.com/content/97543fe0-32cb-4427-a1d2-aac2ea5180fc.

[23] Banca d'Italia, *Decision to Reciprocate a German Macroprudential Measure Pursuant to Recommendation ESRB/2022/4 of the European Systemic Risk Board*, 20 October 2022, https://www.bancaditalia.it/compiti/stabilita-finanziaria/politica-macroprudenziale/esrb-20221020/index.html.

[24] European Central Bank, Eurosystem *Reply to the European Commission's Public Consultations on the Renewed Sustainable Finance Strategy and the Revision of the Non-Financial Reporting Directive*, 8 June 2020, p. 20, https://www.ecb.europa.eu/pub/pdf/other/ecb.eurosystemreplyeuropeancommissionpubliconsultations_20200608~cf01a984aa.en.pdf.

[25] Danilo Liberati and Giuseppe Marinelli, "Everything You Always Wanted to Know about Green Bonds", cit.

[26] Deutsche Börse, *Segment for Green Bonds*,

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green bond issuance to the EU taxonomy could stimulate capital-raising for the transition and avoid greenwashing. An initiative on this matter is the European Green Bond Standard (EUGBS), a certification that attests that bond issuers are aligned with taxonomy criteria. However, the Standard is also voluntary and there is no obligation for an issuer to adhere to it to market its financial products as green bonds.[27] A better solution would be the establishment of the EUGBS as binding to define bonds as green. This would guarantee a harmonisation of green bonds across the EU that would lead to a more coherent language for financial operations for Italian and German actors.

Looking ahead

It is becoming increasingly urgent to direct financial flows toward the transition. Public finance in Germany and Italy is facing difficulties, and market instability has made it riskier for private financial actors in both countries to invest in green projects. Both the German and Italian financial sectors have been more focused on lowering risks than increasing returns, resulting in lower-than-average profitability, which has directly impacted available resources for new investments.[28]

To attract capital toward net-zero opportunities, there is a need for collaboration between public and private actors, as well as bilateral coordination between the two countries. The recent Italian German Action Plan offers a positive model to strengthen coordination, as it includes the establishment of a bilateral macroeconomic forum to discuss financial and economic issues, and it could be an ideal platform to align the two countries' positions on EU-wide reforms, such as proposals on how to adjust the Economic and Monetary Union and the Capital Market Union in ways compatible with sustainability goals. Public efforts should also be spent to strengthen regulatory frameworks to facilitate and de-risk investment for private financial companies, with Germany and Italy coordinating to develop common financing instruments and derisking strategies. Blended finance models should be explored as a way to promote

June 2019, https://www.boerse-frankfurt.de/en/wissen/wertpapiere/anleihen/green-bonds; and International Capital Market Association, *The Green Bond Principles. Voluntary Process Guidelines for Issuing Green Bonds*, June 2021, https://www.icmagroup.org/sustainable-finance/the-principles-guidelines-and-handbooks/green-bond-principles-gbp.

[27] European Parliament and Council of the EU, *Regulation (EU) 2023/2631 of 22 November 2023 on European Green Bonds and Optional Disclosures for Bonds Marketed as Environmentally Sustainable and for Sustainability-linked Bonds*, point 20, http://data.europa.eu/eli/reg/2023/2631/oj.

[28] International Monetary Fund (IMF), "Germany: Financial Sector Assessment Program. Technical Note–The Determinants of Bank Profitability", in *IMF Country Reports*, No. 22/273 (August 2022), https://www.imf.org/en/Publications/CR/Issues/2022/08/10/Germany-Financial-Sector-Assessment-Program-Technical-Note-The-Determinants-of-Bank-522098; and IMF, "Italy: Financial Sector Assessment Program. Technical Note–Banking Regulation and Supervision and Bank Governance", in *IMF Country Reports*, No. 20/236 (August 2020), https://www.imf.org/en/Publications/CR/Issues/2020/08/03/Italy-Financial-Sector-Assessment-Program-Technical-Note-Banking-Regulation-and-Supervision-49633.

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capital raising. A relatively small amount of public funds, constituting a risk cover guarantee, can help catalyse additional private investment. This can take various forms, such as Germany's two auctions model. The initiative consists of two auctions organised by the Federal Government. The first is a descending price auction held between producers to secure long-term contracts for hydrogen supply. The second is an ascending price auction to sell the purchased hydrogen to the highest bidder. Typically, the price requested by the producers in the first auction is higher than what the final buyers offer in the second one and, as a result, the Federal Government bears the additional cost as a form of indirect subsidy to bridge the gap between them.[29] In this way, 900 million euros were provided for the purchase of hydrogen above market prices which allowed the ramp-up of private hydrogen companies, contributing to lower the perceived risk of investing in them and attracting risk-averse private investments.[30]

As Germany and Italy navigate market instability, blended finance offers a promising solution, as it may alleviate both the burden on public funds and mitigate risks for private investors. However, to ensure long-term success, both countries must prioritise wider strategies that enhance profitability for investors committed to decarbonisation. This could be achieved through enhanced bilateral coordination to review regulatory gaps not addressed by broader EU frameworks. Tailored bilateral solutions between Germany and Italy will be essential to develop stable market conditions that align with both countries' financing needs and climate goals.

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[29] German Federal Ministry for Economic Affairs and Climate Action, "What Exactly Is H2Global?", in *Energiewende direkt*, No. 01/2022 (4 February 2022), https://www.bmwk-energiewende.de/EWD/Redaktion/EN/Newsletter/2022/01/Meldung/direkt-account.html.

[30] German Federal Ministry for Economic Affairs and Climate Action, *Roadmap on Expected Hydrogen Off-take in Germany in the German-Norwegian Context*, 23 April 2024, https://www.bmwk.de/Redaktion/DE/Downloads/P-R/240424-roadmap-deu-nor-hydrogen-task-force.pdf.

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