INSTITUT MONTAIGNE

Welcome to the Climate Club: Prospects for Europe and East Asia

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EXECUTIVE SUMMARY

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Can a climate club help accelerate global climate policy in times of geopolitical turmoil?

We are facing an alarming reality. The last UN Climate Change Conference in Glasgow ended with a huge credibility gap between long-term commitments and short-term pledges, keeping the world from reaching the 1.5°C Paris Agreement target. The war in Ukraine has triggered an inconceivable reshuffling of the global energy scene, bringing back old energy security patterns in favor of emission-intensive coal. Finally, China's decision to cancel climate policy discussions with the United States after Nancy Pelosi's August visit to Taiwan is yet another barrier to multilateral climate cooperation. **This geopolitical situation casts a pall over COP27 and questions the capacity of countries to accelerate climate policy ambition**.

Growing climate policy stringency in Europe stoked fears over the existential threat of carbon leakage[1], and thus lent critical importance to protective measures such as the future **Carbon Border Adjustment Mechanism (CBAM)** and the prospect of more international cooperation with trade partners.

Discussions are currently ongoing at the G7 level, further supported by the incumbent German presidency, about the establishment of a **climate club of countries to enhance the international race toward net zero**. A climate club aims to **couple mutually agreed incentives and enforcement measures** by fostering faster **climate policy integrations** in matters such as carbon pricing, but also trade and industrial policy. It represents a new attempt **to overcome the free-riding risk resulting from the lack of enforcement mechanism in the Paris Agreement**.

The decision to use the G7 as a platform to discuss climate club **raises questions** because a truly transformational climate club would probably have to be larger than the G7. This means involving major emitters like China, which entails significant challenges. In this context, **the role played by Northeast Asia, the world's largest emitting region, is central to the debate over the implementation of an ambitious climate club**.

This research paper analyzes European, Japanese, Chinese, and South Korean stances and policies on the climate club initiative, and gauges political support for such a proposal. It uses a comparative climate policy analysis perspective and builds on a two-day policy dialogue that took place in July 2022 and a survey of more than 70 stakeholders from Europe, Japan, South Korea, and China. This paper provides policy recommendations for **the creation of an open Climate Forum through the G7 initiative** and analyzes the following dimensions:
- the **role of carbon pricing and carbon border adjustment mechanism** (CBAM) in a climate club;
- the **potential of common industrial policies** to reach carbon neutrality;
- the **governance and structural design** of a climate club;
- and finally, **the most appropriate strategy to enhance global climate policy**.

How to include carbon pricing in a climate club?

The adoption in Glasgow (COP26) of a rulebook for Article 6 of the Paris Agreement supports further international cooperation using International Transfer of Mitigation Outcomes. However, heterogeneities of carbon pricing design, tailored for each country's situation, obstruct international cooperation. **The views of Europe, China, South Korea and Japan regarding the role of carbon pricing in the future are critically different**.

This research paper reveals that the establishment of a common carbon price in a climate club is at odds with the **need for differentiation, at a sectoral, national, or sub-national (regional) level**. It displays that ambitious international cooperation like ETS linkage should be seen as a tool for nudging climate policy in the right direction, rather than as a standalone objective for a climate club. Furthermore, **carbon pricing cannot be the only objective of a climate club**

1 The EU Commission defines carbon leakage as the situation that may occur if, for reasons of costs related to climate policies, businesses were to transfer production to other countries with laxer emission constraints.

tasked with raising ambitions quickly. The inclusion of explicit carbon pricing as a mandatory membership condition also appears to be counterproductive as it conflicts with the club's inclusiveness. **Therefore, a climate club should focus on fostering increased understanding and much-needed harmonization of carbon pricing policies with specific objectives**.

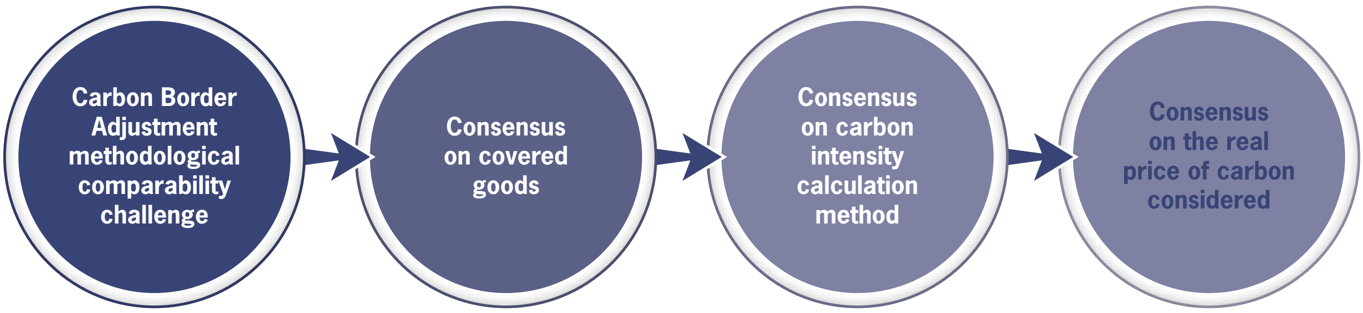
Designing a compliance mechanism: carbon border adjustment in a climate club

Carbon border adjustment represents the **"stick" dimension of a transformational climate club** and allows for stringency within the club. Ideally, a club should implement a CBAM to protect members from carbon leakage and encourage non-members to join. The EU is implementing its own CBAM to account for emissions embodied in traded goods. Denounced by its harshest critics as a form of unilateral protectionism and **viewed with some level of skepticism in Northeast Asia**, CBAM is a politically complex and sensitive issue. **This paper reveals crucial issues for more international cooperation on carbon border adjustment**.

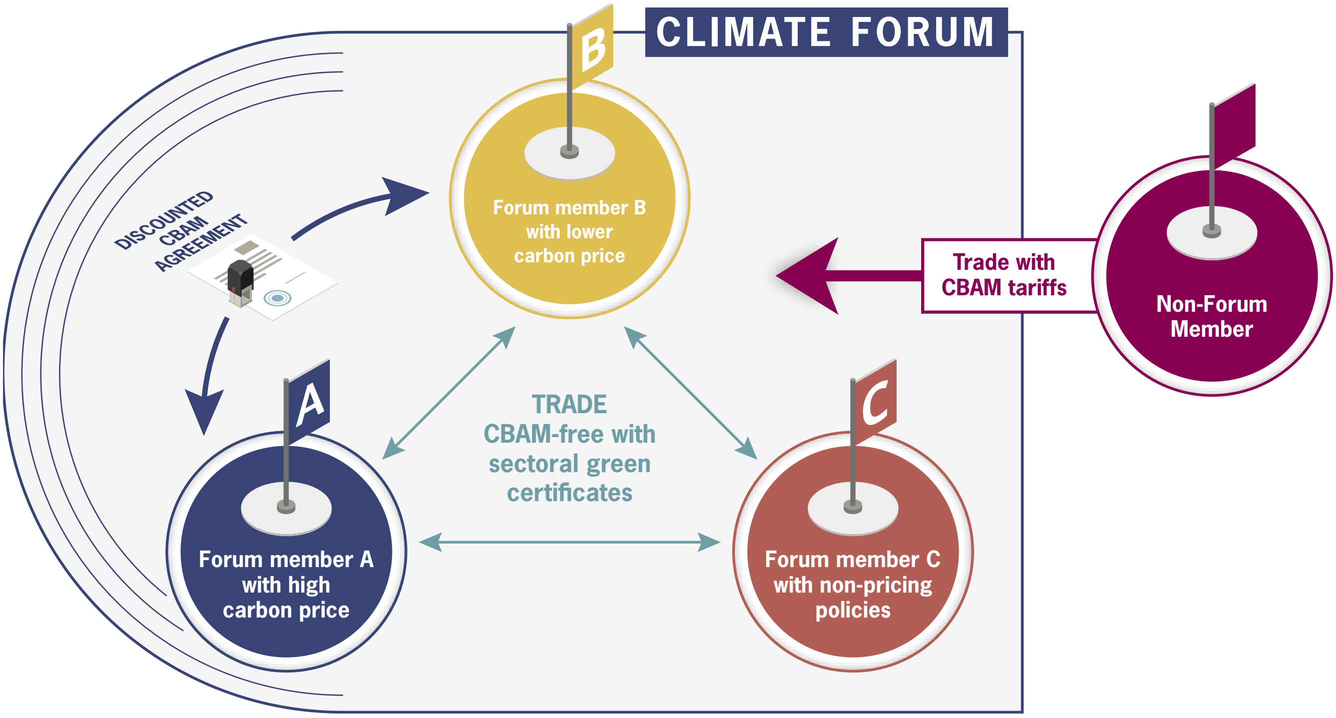
There is no common understanding of carbon leakage between the EU and the three Northeast Asian countries studied in this publication.

Despite being an instrument not inherently contrary to international trade rules, Northeast Asian stakeholders **are concerned over the potential differential treatment of exporters based on their country of origin**. Chinese authorities are the harshest critics of CBAM, which they consider redundant with Paris Agreement article 6. They are even **leading a coalition of countries (joined by countries of the BRICS and the BASIC platforms such as Russia, India, Brazil, and South Africa) against the EU-CBAM**. On the other hand, European policymakers consider CBAM as justified differentiation. This massive difference between the European and Northeast Asia perspective reveals a fundamental problem behind the interpretation of trade discrimination. It also raises the crucial question of **what factor should prevail to regulate emissions embodied in trade: carbon pricing exclusively, carbon intensity, or a mix of both?**

A climate club among major trading partners **must therefore help reduce the huge differences in carbon border adjustment approaches that currently exist**. The legitimacy of such a climate club depends on **future political agreement about these divergences and on methodological comparability** between members:



In light of this research, the only feasible option to have a carbon border adjustment agreement to be included in a climate club would be to establish **a Climate Forum where members implement their own differentiated CBAM**, without eliminating tariffs between members. This approach of differentiated CBAMs does **allow for discounts to be agreed upon in two ways: through an agreement between two club members that overcome the comparison barriers and put carbon pricing and non-carbon pricing measures on the same scale, or through the use of sectoral green certificates.** This could also promote the club's inclusiveness by opening to as many members as possible, including developing countries.

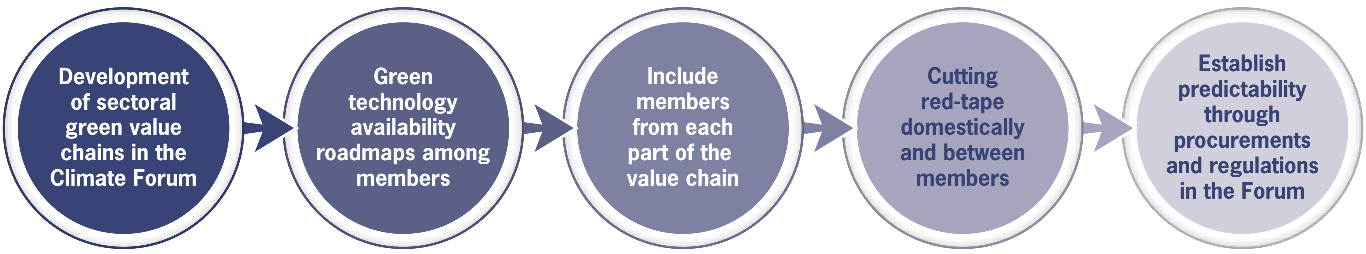


Establishing common industrial policies in a climate club

Sectoral climate clubs with key partners are increasingly considered the **only option for decarbonizing carbon-intensive industrial sectors worldwide**, such as the steel and aluminum industries. These sectors require international policy alignments to address technical, economic, and political uncertainties, which would be facilitated by a climate club. It also entails coordinated incentivization of green market formation by stimulating carbon-neutral products demand through green procurement, standards, and investments. This reality is **widely understood and the most consensual within Europe and Northeast Asia**.

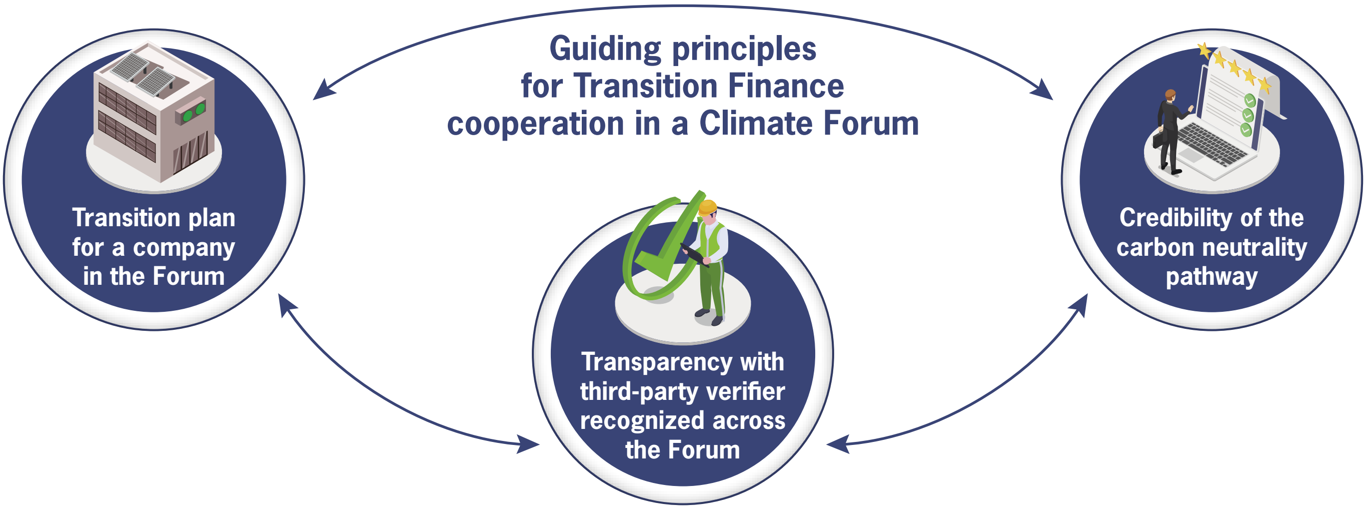
However, **current crucial divergences between partners in Europe and Northeast Asia** complicate the achievement of a true level playing field. To move forward, the following key divergences need to be addressed:
- the list of **key sectors considered** for decarbonization;
- the **legal bindingness of the different policies implemented**;
- the sectoral implications of **subnational or regional economic differences**;
- the choice of **which partners to cooperate with**;
- the interpretation of **existing format** (e.g., for China: the Green BRI).

Against this backdrop, this paper recommends **using a Climate Forum to firstly enable members to partner on selected carbon-intensive industries, and then**, in the longer term, to agree on the structural processes for common industrial decarbonization policies. This Forum entails specific steps described in the figure below:



For political feasibility, in **a flexible climate club, partners do not need to agree on every measure:** the fostering of collaborative spirit leads to productive exchanges on standardization whilst making room for diversity in perspective. It, therefore, signifies **fostering agreement on adopting standards allowing methodological comparability of differing domestic policies and using sectoral green labels negotiated by Forum members**.

Finally, **finance to decarbonize the industrial sector** is widely recognized as important in Northeast Asia and Europe, particularly **for sectors lacking short-term green transition potential. In turn, there is a need for international cooperation** in the finance sector to scale up industrial decarbonization, **both outside and within the club**. However, here again, there are **critical heterogeneities between jurisdictions in terms of sustainable finance policy development and definition.** This paper recommends three guiding principles to foster transition finance in a Climate Forum as described below:



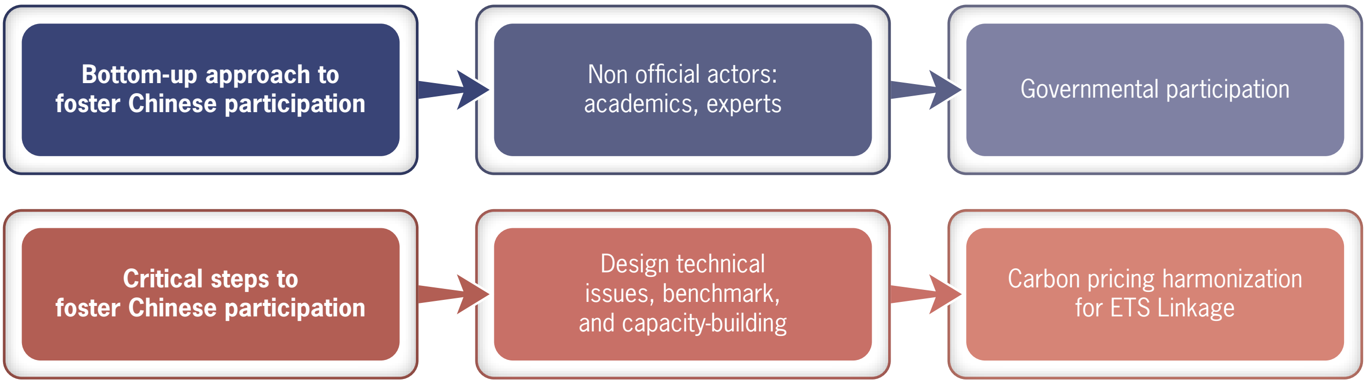
Governance: an open Forum but enabling fast actions…

European and Northeast Asian stakeholders clearly converge on a number of goals and guidelines for the design and governance of a successful transformational climate club. In that regard, it should at least embrace the following objectives:
- **Enable methodological comparability**;
- **Facilitate the establishment of benchmarks and standards**;
- **Adopt a transition roadmap per sector**;
- **Endorse finance mechanisms**;
- **Comply with international trade rules**;
- **Define a clear and rigorous framework**, with a **regular and transparent working structure**.

Therefore, a climate club should be a Forum **promoting synergies**, for instance with existing bilateral arrangements, and **avoid inhibiting ongoing ambitious climate mitigation strategies at all costs**, such as the EU-CBAM. It should also enable an **evolutionary step up, beyond simply respecting the range of existing initiatives**, because of the urgent need for a global expansion of ambition at all levels.

With respect to membership conditions, **there is a tension between the drive to promote inclusivity and the need for strict rules.** As a minimum prerequisite, aspiring partners must **commit to legally binding carbon neutrality targets and sustainable mid-term and long-term decarbonization strategies**. The Forum should also allow corporate membership and apply the **principle of subsidiarity for sub-national jurisdictions membership**, especially in federal countries.

The inclusion of China in a Climate Forum will not be easy at all. China is suspicious of the initiative, suspected of being too close to the American interests. China is not inclined to participate in an international format it did not initiate and that would lock China in an agenda it does not fully control. The country is also reluctant to carbon border adjustment. **However, there are decisive steps that could be taken to facilitate Chinese participation** as sketched below:

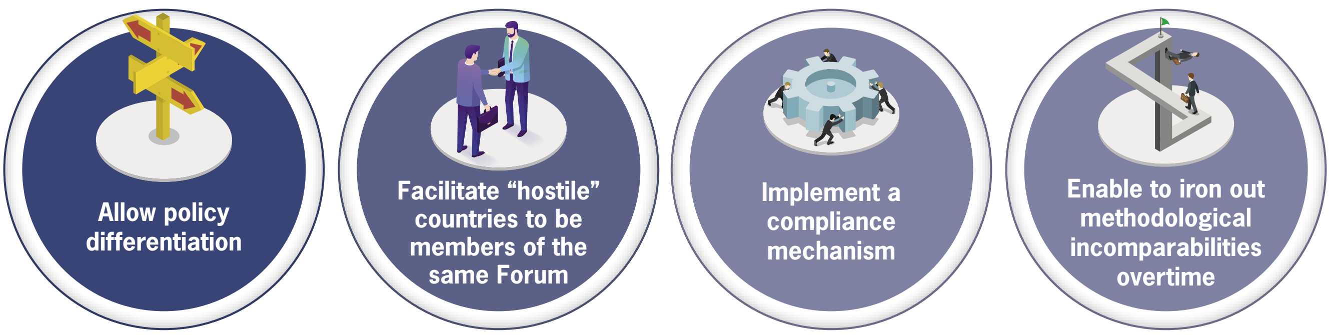


The Forum should aim at developing its own secretariat that could be handled by the OECD as an interim measure. It should itself **be registered under Paris Agreement, Article 6.8**, bolstering recognition and complementarity with the Paris Agreement regime. In the longer run, the Forum should consider **using Article 6.2 mechanisms to implement deeper carbon pricing cooperation between members**.

Recommendations: the establishment of Climate Forum enabling competition

To be effective, the Climate Forum must allow for differentiation of climate policies among members and aim for the largest participation possible to enhance its impact. Thus, **any attempt to create a climate club should try to involve China as a member, but not at the expense of slowing down indefinitely the club formation**. Therefore, the Forum should be based on **four pillars presented in the figure below**:

Four pillars for a feasible Climate Forum



To be effective, a climate club should not prevaricate for too long. Thus, the Forum should build on the current G7 initiative that is most likely to be beneficial for climate action. It should take a proactive stance, accept some risk of confrontation to encourage greater ambition over time, and **assume competition between countries**

by adopting a format that enables sub-groups of members to form. It entails starting **small** but beyond the sole G7 members, and using a forum-like design open to all countries willing to participate (like China and South Korea). This G7-initiated Forum should be based on three simple principles. First, **members can choose the sectors in which they wish to cooperate. Second, members can decide which members they want to cooperate with**. Third, members **can control the timing of this cooperation** (when they deemed they are ready).

This strategy recognizes that some major emitters might join the Forum at first without great involvement. Instead, countries will be incentivized to deeper participation or to join the Forum gradually, through the political risk of not participating with most integrated members in the setting of crucial measures: the common sectoral decarbonization agendas, the development of rules and standards for sectoral decarbonization, joint procurements, and industrial cooperation. This format enables countries to cooperate on specific sectors they deem crucial for their decarbonization. It also allows for membership and gradual cooperation of countries that are initially reluctant to cooperate.

The following tables outline these recommendations for the design of an open Forum based on the perception of an achievable climate club between European and Northeast Asian stakeholders.

	Recommendations 1: Governance ***Design an open and inclusive Climate Forum***
	To achieve the Forum's goals, **different levels of memberships** implying **different levels of integration per sector and policy** should be considered: the Forum should allow different sub-groups of members to cooperate on certain topics.
Membership conditions (common grounds)	Already implemented explicit **carbon pricing should not be a membership condition**.
	Having a legally binding national carbon pricing implementation roadmap and/or legally binding carbon intensity policies (implicit carbon pricing) should be a membership condition.
	Binding carbon neutrality roadmap with long-term strategies should be a membership condition.
	Legally binding plan of declining cap of emissions should be a membership condition (emission peak fixed in the law for developing countries).
	Corporations active in the sectors handled by the Forum should be allowed as proactive members.
	The Forum should apply the **principle of subsidiarity** and be open to relevant subnational jurisdictions, especially in federal countries, when possible.
Link with the Paris Agreement	The Forum should also be registered under the **Article 6.8 of the Paris Agreement** (non-market approach).
Institution	The **OECD** could serve as an interim secretariat, prior to the establishment of a **proper institution to the Forum**.

	Recommendations 2: Pricing carbon ***The achievable establishment of a compliance mechanism in a Climate Forum***
Carbon Pricing	The Forum should be a cooperation platform upon which **member countries can work towards carbon pricing harmonization**.
	Club membership should initially be the vehicle to establish **commonly agreed MRV standards** between members of the club.
Linking of carbon pricing systems	Linking domestic carbon pricing policy **should optionally be the mid to long-term objective** of forum membership, using Article 6.2 of the Paris Agreement. Willing and compatible jurisdictions should create a sub-group of the Forum as an harmonization tool aiming ETS linkage.
Carbon border adjustment	The Forum should recognize carbon price heterogeneity in the short-to mid-term and **become an instrument for cooperation on border carbon adjustment, without aiming at a common carbon border adjustment mechanism** for member countries.
	Each partner should implement carbon border adjustment at their own political pace, the **Forum should foster CBAM capacity-building among members**.
	Club membership should not exempt from carbon border adjustment among Forum members to account for carbon pricing differentiation. This creates an incentive to stringency to access CBAM-free the market of the most ambitious members.
Differentiated carbon border adjustment	The Forum should foster differentiated CBAM **rates between members established on calculated and comparable decarbonization effort (pricing or non-pricing measures) based on accurate and verifiable data**.
	In order to facilitate differentiation, the **Forum should enable comparability of members' pricing and non-pricing measures by fostering:** • Agreements on **measurement for carbon content of goods** (sectoral). • Agreement on **essential vs non-essential** goods covered. • Development of **sectoral green labels**.

	Recommendations 3: Labels and revenues ***The financial and trade incentives***
Incentive to join the club	Incentive comes from **the level of CBAM rate (discounted or not)**.
	The **availability of green labels**.
	Facilitate the demand- and consumption-based approach through the **better recognition of measurement of the carbon content of exported and imported goods**.
	Access to common green development projects.
Green labels	Foster the adoption of **sector-specific "green certificates" for companies from members willing to adopt the highest carbon content standards for goods and export them CBAM-free throughout the club**.
	Resolve concerns about administrative burden by using the incentive for companies to be exempted from CBAM throughout the club.
	Green labels should be sectoral-based, allowing members to participate in some sectors but not others. This would allow a group of more advanced members to move forward more quickly together, without being slowed by the participation of less advanced partners.
Revenue-use and climate finance	**Each partner should keep their own CBAM revenues recycled for climate actions domestically, or abroad through Forum initiatives**.
	Part of CBAM revenues could be mutualized between most integrated members to fund ambitious collaborative mitigation and adaptation projects sponsored by the Forum. In this sense, revenues could act as a strong incentive to join the Forum, especially for developing countries to access better climate finance.
Climate finance	To avoid green washing in climate finance, the **Forum should promote traceability and transparency of data across the Forum through agreed MRV standards**.
	The Forum should promote **greater understanding, consistency, and legal bindingness of green taxonomies**, particularly in sectors of cooperation.

	Recommendations 4: Industrial decarbonization ***Industrial policies in the club***
Sectoral approach for industrial decarbonization	The Forum should **enable greater cooperation in critical sectors of interest (steel, aluminum, hydrogen and clean energy) and allow members to choose the sectors in which they want to cooperate**.
	The Forum should establish technology availability roadmaps to identify points of collaboration and synergy.
	The Forum should **foster common understanding and experience-sharing for green transition finance per sector**.
Level playing field for carbon neutral goods	The Forum should be a **negotiation platform for level playing field per sector**.
Green market formation	The Forum should **stimulate demand for carbon neutral goods** through common green procurement, and common investments.