

How to accelerate the shift to circular economy – attractive financing needed

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The high starting cost of investment, and political and market uncertainties halt the transition to a circular economy, according to new research from Frankfurt School of Finance and Management,

The researchers show how financial instruments can help overcome major challenges hindering the transition, and how development cooperation could contribute to closing the financing gap for the circular economy in low- and middle-income countries.

This shift is vitally important, say the researchers, given that the concept of a circular economy is an essential building block for achieving the Paris Climate Agreement and the Sustainable Development Goals, and the European Union (EU) recognise the transition to a circular economy in the EU Taxonomy for sustainable activities, which must be applied by financial institutions starting in 2023.

In cooperation with the Gesellschaft für Internationale Zusammenarbeit (GIZ), the Frankfurt School – UNEP Collaborating Centre for Climate & Sustainable Energy Finance assessed the current circular economy market, as well as the financial instruments that can be used to boost its benefits, the challenges and barriers that need to be overcome.

The researchers state that substantial economic benefits are emerging from the circular economy, which have gone largely unexplored. For instance, the Circularity Gap Report 2021 estimates the additional economic output for circular businesses to be USD 4.5 trillion by 2030. However, only 8.6 percent of the global economy is currently described as circular.

The barriers stopping governments and firms from transitioning to the circular economy are complex, say the authors. A number of barriers trigger financial market imperfections, including large upfront costs, a lack of available blending instruments, market uncertainties, political uncertainty, and insufficient regulatory environments.

All of these barriers can lead to market imperfections, which halt circular transition by causing unpriced positive and negative consequences of the investment, such as societal costs, imperfect capital markets, lack of information for private actors, and other market distortions such as corruption. In essence, the return on a circular economy investment is always connected to an environmental, social and, in the end, developmental return on investment, which is hardly addressed in the current dominating “take-make-dispose” economy.

Michael König, Project Manager at Frankfurt School – UNEP Collaborating Centre for Climate & Sustainable Energy Finance:

“Prevailing linear production and consumption practices lead to an immense waste of resources, pollution, loss of natural ecosystems and biodiversity. The core principle of the circular economy stands in opposition to the linear economy, and now, more than ever, it is increasingly important, not only from an environmental but a financial perspective, to make the transition to this circular economy.”

The study does, however, show that the demand for financial products facilitating green and circular projects has risen sharply in recent years. Though there are many barriers to entry, a sustainable and circular finance practices can transition to a circular economy, including resource efficiency by focussing on value preservation and keeping product cycle at the highest value possible.

The researchers also studied a number of industries and the specific barriers they are facing in terms of transitioning to the circular economy. The study offers specific approaches to overcome these challenges, including the development of circular procurement policies, extended producer responsibilities (EPR) regulations, life-cycle costing approaches, or eco-Special Economic Zones.

Additionally, the authors used the example of five low- and middle-income countries – Albania, the Dominican Republic, Colombia, Rwanda, and Vietnam – to show to what extent established and innovative financing mechanisms such as sustainability-linked bonds, circular credit-lines, or product and financial leasing can be used more intensively. With the obtained results the authors derived recommendations for the German development cooperation.

This study was published at the UN environment conference, Stockholm +50, in June 2022.