



ASIA HOUSE **RESEARCH**

CHINA'S DECARBONISATION

ASSESSING UK-CHINA OPPORTUNITIES

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CONTENTS

EXECUTIVE SUMMARY.....	4
UK-CHINA CLIMATE NEXUS TAKES ON INCREASED IMPORTANCE.....	5
1.1 The UK Net Zero 2050 Strategy	
1.2 China's 30/60 Climate Ambitions	
FOUR KEY OPPORTUNITIES FOR CHINA-UK CLIMATE COOPERATION.....	6
2.1 Recommendation 1: Accelerate scale, breadth and depth of green finance	
2.2 Recommendation 2: Further develop international carbon markets	
2.3 Recommendation 3: Co-finance greener infrastructure development	
2.4 Recommendation 4: Deepening cooperation on climate innovation	
RISKS AND CHALLENGES TO THE UK-CHINA CLIMATE PARTNERSHIP.....	9
NOTES AND REFERENCES.....	10



EXECUTIVE SUMMARY

Global climate change risks are growing and will increasingly feed into broader financial stability risks across economies. This report presents four key recommendations for UK-China coordination on decarbonisation, in order to help mitigate against climate impacts.

The two countries should elevate their cooperation on greater use of green finance, including by the further de-risking of green projects through blended finance. This includes new green financing tools and products with a focus on scalable solutions across asset classes. The two countries' financial systems' depth (in the case of the UK) and prospects for liberalisation (in China's case) ideally situates them. Additionally, linking emissions trading systems (ETS) would accelerate cooperation between jurisdictions and the growth of international carbon markets. Improvement of price discovery mechanisms is key.

The outlook comprises a myriad of risks. These include a continued lack of investable projects to facilitate reduction in CO₂ emissions, waning political will and resources at a time when emerging and developing countries, which are most vulnerable to climate change, are coping with economic scarring from COVID-19.

KEY TAKEAWAYS

- Global climate change risks are becoming increasingly multifaceted. Climate risks now feed into broader financial stability risks across economies.
- This report presents four key recommendations for UK-China coordination on decarbonisation. Both countries should elevate cooperation on expanding the use of green finance.
- The UK's tackling of the climate crisis, and bolstering of green finance, is supported by the Chancellor's announcement that the government plans to situate the UK as the world's first net zero aligned financial centre.
- Risk-sharing facilities and use of blended finance to de-risk green projects are key. This includes new green financing tools and products.
- Both countries can share expertise and build capacity in third countries to identify and develop sustainable projects.
- Increased financing for environmental innovation within existing initiatives (such as the £200mn Newton Fund) is important, particularly for research at the intersection of environmental technology, energy and urbanisation.
- When it comes to green finance, the UK and China can drive a global green innovation agenda. Forums such as the Clean Energy Ministerial can be instrumental in achieving this.
- The global uptake of shared priority technologies, such as in hydrogen power, need greater global support: global demand for hydrogen needs to more than double from its existing level by 2030 if the world is to attain climate goals.
- The outlook comprises a myriad of risks. These include a shortfall in blended finance to yield investable projects and a lack of political will amid COVID-19 economic scarring.

1. UK-CHINA CLIMATE NEXUS TAKES ON INCREASED IMPORTANCE

Global climate change risks are growing in importance and becoming increasingly multifaceted. Climate risks now both constitute and feed into broader financial stability risks across economies. Among other challenges posed by climate change, it is now increasingly identified as an emerging and increasing threat to economic stability. Most recently, the US Treasury's Financial Stability Oversight Council identified climate change as an emerging threat to US financial stability (US Department of the Treasury, 2021). This is likely to be mirrored in other advanced and developing economies as climate impacts grow and countries' governance systems and economic response mechanisms catch up to climate change.

Financial, economic and investment links make a UK-China partnership essential for successful energy transition in both countries. China has committed to reaching peak carbon (CO₂) emissions by 2030 and reaching carbon neutrality by 2060. Achieving this will be costly and could require US\$21.3 trillion in investment by 2060.¹ The UK, too, has recently unveiled its net zero strategy mapping out the constituent pathways to reaching net zero CO₂ emissions by 2050. China's decarbonisation is essential: it became the world's largest emitter of carbon dioxide (CO₂) in 2006 and is now responsible for well over a quarter of the world's overall greenhouse gas emissions (Boden et al., 2017).

This report analyses four key opportunities for China and the UK to work together on decarbonisation, and builds on recommendations initially put forward in previous Asia House Research (Asia House, 2021a). The recommendations are predicated on the notion that essential UK-China areas of collaboration naturally link to bilateral trade and investment in cleantech, hydrogen, carbon capture and storage (CCS) technologies and low-carbon technologies. The analysis takes stock of recent progress and elaborates on the importance of further efforts. The report also assesses some of the major risks in implementing plans for decarbonisation.

1.1 THE UK NET ZERO 2050 STRATEGY

This autumn, the UK government announced its strategy to reach net zero CO₂ emissions by 2050.² Its strategy includes plans to create up to 440,000 jobs and to leverage up to £90 billion in private investment by 2030, in large part, from private sector companies. The strategy includes expanding production of electric vehicles (EV), increasing hydrogen production by mobilising investment of between £20-30 billion, which would halve UK emissions from oil and gas, further significant investment in offshore wind and in new hydrogen technologies. The strategy also targets £120

million for a Future Nuclear Enabling Fund, building the basis for future nuclear technologies.

The UK net zero strategy sets out a broad-based plan. Of particular importance are the types of incentives and sector-specific ecosystems that will be put in place in the UK to support businesses and consumers to make the transition to clean energy and green technology. This will be crucial in fostering an environment for enhanced innovation in new technologies. The government has announced its plan to utilise, and increasingly employ, low-carbon solutions such as hydrogen and carbon capture and storage (CCS) to decarbonise industrial clusters. More recently, the UK government has started to set out plans for the UK to be the world's first net zero aligned financial centre.³

1.2 CHINA'S 30/60 CLIMATE AMBITIONS

President Xi Jinping's announcement of the goal to reach peak CO₂ emissions by 2030 and to carbon neutrality by 2060 was Beijing's first formal announcement of a long-term carbon reduction plan with a timeline (Yep, 2020). Soon after, additional 2030 climate targets were announced at the Climate Ambition Summit.⁴ These included scaling up China's nationally determined contributions, lowering carbon dioxide emissions (per unit of GDP, by over 65 per cent from 2005) and increasing the share of non-fossil fuels in primary energy consumption to 25 per cent.

Recent policy developments have been particularly notable. In their recent guidance, the government stated that it will improve policies for encouraging nongovernmental capital and motivating market entities to invest in green and low-carbon solutions. And that State-owned enterprises will scale up green and low-carbon investment.⁵ Most notably, at the UN Climate Change Conference (COP26), China signed a joint declaration with the United States signifying joint cooperation on tackling the climate crisis. Elements of their enhanced cooperation include regulatory frameworks and the deployment and application of innovative technologies.⁶

Essential to China meeting its climate goals is its sustainable urbanisation. The 13th Five-Year Plan (2016-2020) supported green urban development by expanding low-carbon city projects to over 100 cities. This was supported by the "New Infrastructure" initiative launched in 2020, aimed at mobilising public and private capital for low-carbon developments. In tandem with this, China aims to increase its forest coverage rate to roughly 24 per cent by 2025 and plans to expand its national parks to cover as much as 18 per cent of its land area by 2025. This will continue to improve China's carbon sink intensity.⁷ Sustainable urbanisation and development is also echoed in the 14th Five-Year Plan (2021-2025), which prioritises the quality of growth over quantitative targets.



2. FOUR KEY OPPORTUNITIES FOR CHINA-UK CLIMATE COOPERATION

UK-China climate cooperation is both essential and opportune, particularly as President Xi Jinping and Prime Minister Boris Johnson have reached an important political consensus on coordination.⁸ The UK has unique strength in clean energy and low-carbon technology while China has the technology to operate and manage clean energy. Third, international cooperation is key to greening the Belt and Road initiative (BRI). To the extent that financial institutions can be a lever for regulating and aligning investments with climate change targets, the UK is ideally situated given the scale and breadth of its financial sector.

With this backdrop in mind, four areas of UK-China collaboration are essential to strengthen and to build on past progress.

2.1. RECOMMENDATION ONE: ACCELERATE SCALE, BREADTH AND DEPTH OF GREEN FINANCE

The UK and China should continue to accelerate cooperation on greater use of green finance through risk-sharing facilities, co-funding and de-risking green projects through blended finance, the promotion of green finance and green bonds. In line with building an array of financing initiatives, an investment climate that not only supports, but favours green small and medium-sized enterprises (SMEs) is crucial. In particular, developing ecosystems that promote a higher level of coordination and connectivity in financing is particularly catalytic (Asia House, 2021b).

Green finance is crucial to fund China's low-carbon transition. The distribution of and access to bank lending continues to be cited as a difficulty among China's SMEs. China's restrictive borrowing standards (such as collateral requirements of twice the loan amount) reflect the perceived risk profile of SMEs (Lam and Liu, 2020). As with much of the rest of Asia, in the absence of affordable bank loans, some larger firms are turning to bond market financing. Since its inception in 2016, China's green bond market has grown in scale, depth and diversity. Issuance is largely

within its onshore market, with remaining issuance via offshore financial centres (IMF, 2019).

Green bond issuance remains essential for China's energy transition. In 2020, notwithstanding the economic and financial impact of the COVID-19 pandemic, China was the world's second largest green bond issuer after the US, by issuance amount. At US\$44 billion, its issuance accounted for approximately 15 per cent of the global total (Climate Bonds Initiative, 2020). In the first half of 2021, issuance has grown threefold to US\$194bn, according to Refinitiv. Under its 14th Five-Year Plan, carbon-neutral bonds have been launched to fund low-carbon projects, including in clean energy, clean transportation and green buildings. Corporate issuers are required to provide independent third-party evaluation and verification.⁹

The UK and China have already started to build a foundation for cooperation in climate finance. They have set a global example for cooperation through the UK-China Green Finance Centre.¹⁰ London has large pools of capital as well as green finance expertise and a wealth of increasingly sustainability-oriented investors, with the UK launching its own £10bn inaugural green gilt issuance on the London Stock Exchange in September 2021.¹¹ China has a growing demand for green finance domestically, as well as for projects in third markets and has significant expertise in green finance and policy development.

Through regulatory and financial coordination, the UK and China can increase the depth, breadth and scale of green finance that is accessible in their economies, and globally. As we have cited in the past, both countries need to strengthen the green component of the UK-China Economic and Financial Dialogue (EFD). The UK and China have a regular forum for cooperation on economic policy priorities through the EFD.¹² This forum has delivered milestones such as the London-Shanghai stock connect. The green component of the EFD can be accelerated¹³ through driving high-level discussion regarding the following:

- **Expediting new green financing tools** and products with a focus on scalable solutions across asset classes and the inclusion of both green projects and transition finance (for example, the transition bonds segment that has been launched on the London Stock Exchange). Importantly, this category of initiatives could include multinational institutions in order to promote the greater use of blended finance in order to de-risk and boost access to green projects.

- **Driving greater investment standardisation** by encouraging engagement from global investors and other stakeholders. Enhanced engagement with and for emerging and developing economies that are vulnerable to climate risks should be increased in the regular dialogue around investment standardisation. This is particularly the case for countries where financial markets are developing. The Task Force on Climate-related Financial Disclosure (TCFD) should elevate the involvement of these countries.

- **Harmonising green finance taxonomy** among key global actors is of particular importance alongside a timeline for high level policy and regulatory discussions. With this in mind, the UK and China should also develop a plan for regular discussion and cooperation at the policy and regulatory level, between the annual EFD meetings in order to advance a joint agenda for financing clean energy. This is important in the light of the two countries' financial systems' depth (in the case of the UK) and liberalisation (in China's case).

The UK and China should jointly promote global climate coordination. They have set examples for multilateralism through co-chairing the G20 Sustainable Finance Study Group¹⁴ and the early commitments of the UK and China to implement TCFD recommendations. The UK-China Environmental Information Disclosure Pilot¹⁵ has advanced climate reporting practices. More can be done through forums like the G20, COP, the International Sustainable Finance Platform¹⁶ and the Network for Greening the Financial System¹⁷ of central banks, of which UK and Chinese institutions are members. The agenda outlined above for the EFD should, in time, be expanded globally, and from a foundation of on-going bilateral cooperation, the UK and China can drive the global agenda for green finance.

2.2. RECOMMENDATION TWO: FURTHER DEVELOP INTERNATIONAL CARBON MARKETS

While the UK and Chinese schemes are new and the concept of linking schemes is nascent, the UK and China should build discussions on linking their schemes into future financial dialogues. After ending its EU membership, the UK's scheme is separate from the EU ETS. The UK launched its emission trading system (ETS), which replaced its participation in the EU ETS, on January 1, 2021.¹⁸ China's scheme has been designed

with consultation with the EU¹⁹ so all three schemes will share similar base characteristics.

The UK ETS forms a core part of its climate strategy. It is the world's first net-zero carbon cap-and-trade market with the cap on emissions allowed within the system reduced by five per cent from the EU system it replaces. Initially, the new UK system covers emissions from energy-intensive industries, electricity generation and aviation. Opportunities to expand the UK ETS to cover the two-thirds of remaining uncovered emissions will be explored by the government. This could reduce the costs of cutting emissions, increase market liquidity, stabilise and harmonise prices, and support global cooperation.

On the basis of recent development, the recommendations for UK-China cooperation on ETS would comprise the following:

- **Linking ETS schemes** would accelerate cooperation between jurisdictions, while still being designed to fit local circumstances. Linking could accelerate the growth of international carbon markets, in turn enabling enhanced cooperation and reduced mitigation costs through increased scale. Aligning institutional elements (including registry standards and cooperation between regulators) would hasten linking arrangements too (Evans and Wu, 2020).

- **Improvement of price discovery mechanisms.** Building on regional pilots, China's national emissions trading scheme (ETS), launched in January 2021 is a key tool to price carbon. An enhanced price discovery mechanism would broaden sector coverage. At present, only power plants are covered and the mechanism exerts relatively weak cost incentives. It is expected to expand to cover more sectors such as steel and petrochemicals and be complemented by other market-based instruments, such as resource taxes, emissions fees, and fuel taxes.

- **Voluntary carbon markets²⁰ should be accelerated.** This would further re-orient business models to carbon neutrality. China continues to scale its GHG Voluntary Emission Reduction Programme.²¹ UK companies can purchase credits voluntarily from approved providers. The Taskforce on Scaling Voluntary Carbon Markets, launched by UN Special Envoy for Climate Action Mark Carney, concluded that a large-scale voluntary market will be critical to reaching the goals of the Paris Agreement.

Both China and the UK can share experiences from their own markets and generate discussion on both voluntary carbon markets as well as technical improvements to linking their ETS and price discovery mechanisms. This would expedite the expansion of the markets and incentivize emissions abatements in additional sectors in both economies.

2.3. RECOMMENDATION THREE: CO-FINANCING GREENER INFRASTRUCTURE DEVELOPMENT

China's Belt and Road Initiative (BRI) constitutes a significant portfolio of infrastructural investments in ports, roads, railways and airports, as well as power plants and telecommunication networks. However, increased GHG emissions have been linked to the construction and operation of BRI projects; empirical results indicate the existence of a CO₂ spillover effect between China's outbound foreign direct investment and imports from BRI economies (Song, 2020).

In the past several years there has been considerable focus on 'greening' the BRI to ensure that new infrastructure is developed and employed in a sustainable fashion. Since 2019, Chinese state-led BRI lending volumes have been in decline (Mingey and Kratz, 2021). The BRI now places increasing emphasis on high quality investment, including through greater use of project finance, climate risk mitigation tools, and green finance (CCICED, 2021).

In 2018, the UK and China jointly published the Green Investment Principles (GIP) for the Belt and Road.²² Since then, 37 signatories and 12 supporters from 14 countries and regions have signed up to the principles, which aim to harmonise green infrastructure standards, promote the use of green financial products in infrastructure development, and to reduce the emissions footprint of the BRI. Recently, the Third Plenary Meeting of the GIP successfully concluded in Beijing in September.²³

Looking ahead, follow-up initiatives aligned with the GIP are essential. Elevating environmental standards should include impact assessments and taking even bolder policy decisions. This should include a moratorium on China's domestic coal-fired power plants, not just its coal power plants abroad, and fostering an alternative to coal given the regional economic impact of the moratorium (Yu, 2021). UK-China coordination with banks and multinational institutions, such as the Asian Infrastructure Investment Bank, to boost blended finance, would increase investable green projects. Both countries can share expertise and build capacity in third countries to identify and develop sustainable projects.

2.4. RECOMMENDATION FOUR: DEEPEN COOPERATION ON INNOVATION

UK-China cooperation is growing and underscored by the shared view that innovative strategies to tackle climate change lead to increased efficiency, new technology, and lower economic and climate risk. Significant economic, financial and structural transformation is needed to limit a dangerous degree of warming. In particular, the share of renewables in power generation must move from about 25 per cent

today to almost 100 per cent by 2050. Unabated coal will need to be phased out six times faster than is happening today (Levin and Steer, 2021).

The UK is at the forefront of innovation in hydrogen power, tidal, and offshore wind, with several schemes in place to support its domestic generation. UK Research and Innovation (UKRI) has had an office in China for several years in recognition of the scale of funding, researchers and patents that China produces, and the opportunity for development partnerships.²⁴ China has played a major role in renewable energy technological innovation, which is essential for curbing its CO₂ emissions, alongside its increased renewable energy generation (Lin and Zhu, 2019).

Specific areas for UK-China cooperation could naturally stem from the renewable energy sector and accelerate funding and development in renewable energy in each country, with positive spillover effects:

- **Increase investment partnerships to scale technologies.** China has a good track record of scaling technologies for market that is of significant value to UK innovators. This opportunity could be leveraged both through partnerships in China and increasing the involvement of Chinese investors (and particularly their manufacturing expertise) in UK climate projects. This could have significant benefits for UK regional development.

- **Leverage and increase financing for existing initiatives.** The UK should focus more on its existing initiatives. Both the £200mn UK-China Research and Innovation Partnership Fund (Newton Fund) and the UK-China High Level People to People Dialogue (P2P) could be focused more towards environmental innovation, particularly accelerating research on the intersection between environmental technology, energy and urbanisation.

- **The UK and China can drive a global green innovation agenda.** Forums such as the Clean Energy Ministerial²⁵ can be instrumental in achieving this. The global uptake of shared priority technologies such as hydrogen power, need to receive even greater support globally: demand for hydrogen needs to more than double from its existing level of consumption to 212 million mt by 2030 if the world is to attain climate-change goals (IEA, 2021).

Structural transformation, in multiple sectors, lies at the heart of each country's successful transition to clean energy and to meeting its climate change targets within the announced timelines. Both China and the UK have a proven history of success when it comes to economic transformation and to fostering innovation. Building further cooperation in accelerating innovation is essential for the clean energy transition and should be prioritised.



3. RISKS AND CHALLENGES TO THE UK-CHINA CLIMATE PARTNERSHIP

In the period ahead, it is likely that advanced and developing economies alike will continue to see the spectrum of impacts associated with climate change – something that will continue to drive transformation to reduce CO₂ emissions. And yet, the likelihood of a significant and sustained increase in systemic risk, driven by extreme weather events, droughts, sea-level rises, migration, and other climate consequences, will require more bilateral and global coordination. The transition will bring up a myriad of additional risks which could include:

- **Insufficient de-risking of green investment.** If there is a shortfall of blended finance (combining multinational, private and public stakeholder investment), there would not be enough de-risking of investment in developing and emerging economies. As a consequence, there would continue to be a lack of investable projects to facilitate reduction in CO₂ emissions. The OECD estimates that US\$6.9tr a year is required up to 2030 to meet climate and development objectives. While public financing will cover part of this, private sector financing, particularly through blended finance facilities, needs to be developed.

- **Uneven political will and resources to tackle climate change risks.** There are political challenges that could crystallise into risks. More broadly, there is a divide between advanced economies and industrialising and developing countries in terms of the contributions to cutting global CO₂ emissions. This is particularly the case now, when emerging and developing economies are struggling to recover from the economic and social impacts of the COVID-19 pandemic. Emerging and developing countries – the most vulnerable to climate change impacts - have been hit particularly hard by COVID-19, and are coping with significant economic scarring.

- **Bolstering a new competitiveness is essential.** The EU's proposal for a carbon border tax aims to create a level playing field for local companies who comply with the EU's Emissions Trading Scheme and

other environmental regulations. Government and private sector action tackling climate change should be framed as a core strategic pillar by all stakeholders. Decarbonisation should be seen as an essential sign of a business's willingness to curb climate catastrophe. This will foster a new competitive paradigm. A continuation of a "business as usual" mindset would put progress at risk.

3.1 LOOKING AHEAD: MAKING THE CASE FOR INTERNATIONAL COOPERATION

Both China and the UK's comprehensive approaches to decarbonisation entail shared interests such as innovation and financing the clean energy transition. Both countries also recognise their responsibility to address climate change urgently, through domestic transformation as well as by supporting others. Hence, both have made significant commitments to reduce emissions. Based on these shared interests and commitments, there is a significant shared space for international cooperation between the UK and China on decarbonisation. The transition will present business opportunities across investment and exports of goods and services.

As the recommendations in this paper demonstrate, the climate change challenge will require multiple stakeholders to support a number of initiatives and efforts if we are to move to a sustainable future. There are opportunities for both China and the UK to increase support for critical decarbonisation challenges through their bilateral engagement and cooperation. Many of the strengths and capabilities of the two countries are complementary. This complementarity provides a timely opportunity for China and the UK to increase their global leadership in tackling climate change – arguably the biggest challenge ever faced by humanity.

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If you have any questions or comments about this report, or wish to find out more about Asia House Research, please contact Phyllis Papadavid, Head of Research and Advisory, at phyllis.papadavid@asiahouse.co.uk

NOTES

1. Zhang Shaogang, vice president of China's national foreign trade and investment promotion agency — the China Council for the Promotion of International Trade (CCPIT), has been quoted as stating that China's decarbonisation efforts will require US\$21.3 trillion in investment by 2060 (Yihe, 2021).
2. <https://www.gov.uk/government/news/uks-path-to-net-zero-set-out-in-landmark-strategy>
3. <https://www.gov.uk/government/news/chancellor-uk-will-be-the-worlds-first-net-zero-financial-centre>
4. https://www.fmprc.gov.cn/mfa_eng/zxxx_662805/t1840220.shtml
5. http://english.www.gov.cn/policies/latestreleases/202110/25/content_WS61760047c6d0df57f98e3c21.html
6. <https://www.state.gov/u-s-china-joint-glasgow-declaration-on-enhancing-climate-action-in-the-2020s/>
7. Carbon sink intensity of forests refers to the process whereby forests play an important function in the global carbon cycle, as both a carbon source (through deforestation) and as contributors to the sink that acts as a balancing force (Cannell 1996).
8. <http://www.chinese-embassy.org.uk/eng/dshdjhh/t1824125.htm>
9. http://english.www.gov.cn/news/topnews/202103/01/content_WS603c50bbc6d0719374af9bce.html
10. <https://www.ukchinagreen.org>
11. <https://www.lseg.com/resources/media-centre/press-releases/uk-lists-its-£10bn-inaugural-green-gilt-london-stock-exchange>
12. <https://www.gov.uk/government/news/tenth-economic-and-financial-dialogue-held-between-the-uk-and-china>
13. <https://www.ukchinagreen.org/wp-content/uploads/2020/06/Resilience-Lessons-to-Scale-Responsible-Investing-June-2020-EN-FINAL.pdf>
14. <https://www.mainstreamingclimate.org/sfsg/>
15. <https://www.unpri.org/climate-change/uk-china-pilot-on-climate-and-environmental-risk-disclosure-2nd-year-progress-report/5744.article>
16. https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/international-platform-sustainable-finance_en
17. <https://www.ngfs.net/en>
18. <https://www.gov.uk/government/publications/participating-in-the-uk-ets/participating-in-the-uk-ets>.
19. https://ec.europa.eu/clima/eu-action/eu-emissions-trading-system-eu-ets/international-carbon-market_en
20. Voluntary carbon markets allow carbon emitting companies to offset their unavoidable emissions by purchasing carbon credits emitted by projects targeted at removing or reducing GHG emissions (Favasuli and Sebastian, 2021).
21. <https://www.edf.org/climate/status-chinas-voluntary-carbon-market>
22. <https://green-bri.org/green-investment-principle-gip-belt-and-road-initiative/>
23. <https://gipbr.net/Content.aspx?id=332&type=211&m=8>
24. <https://www.ukri.org/our-work/collaborating-internationally/our-international-offices/ukri-china/>
25. <http://www.cleanenergyministerial.org>

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