CENTRAL BANKS AND CLIMATE CHANGE

Central banks have become increasingly aware of the impact of climate change on price and financial stability. Moreover, by accepting collateral or via asset purchases, central banks are taking explicitly climate risks on their balance sheets. At the European Central Bank, climate change has become integral part of the monetary strategy review launched in 2020. A major question is whether climate objectives should be pursued in the conduct of monetary policy. The fear is that it could be seen as "mission creep". At a minimum, one would expect the ECB to ask for more disclosure concerning climate-related factors for assets held on its balance sheet. But the question to what extent market neutrality should be abandoned in favour of greener objectives is still open. The outcome of the review should be announced in September 2021.

Climate change has been at the top of the agenda since the ground-breaking speech by the Governor of the Bank of England, Mark Carney, before Lloyds of London in 2015.[1] The Governor singled out three channels through which climate change could affect the stability of the financial sector.

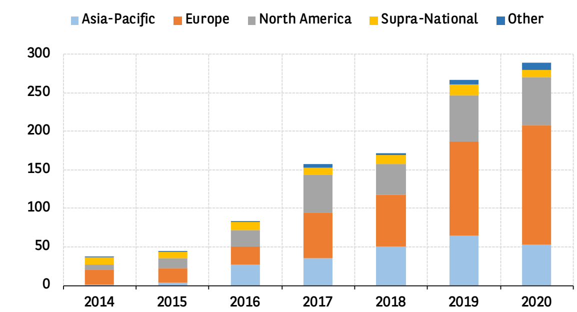
First, physical risk: climate and weather related events can impact insurance liabilities and financial assets through damages to properties and disruptions of trade. Second, liability risk: victims of climate change-related events could seek compensation from those they consider to be responsible, such as investors. Finally, transition risk: the changes in policy and technology could result in asset losses. Extreme examples are stranded assets such as oil reserves that cannot be exploited or nuclear power stations that have to be dismantled because of changes in energy policy. Several of these factors could weigh on the effectiveness of monetary policy. Other developments could have an impact on price stability[2]: increased short-term volatility in output and inflation through extreme weather events; a durable divergence, due to transition policies and innovation, between headline and core measures of inflation influencing inflation expectations of households and businesses; the equilibrium interest rate could decline on the back of lower productivity; finally, assessing the appropriate stance of monetary policy could also become more difficult due to volatility and accelerated structural change.

The Bank of England has continued to play a leading role in the area of climate change. Together with the Banque de France and De Nederlandsche Bank, it took the initiative of setting up the Network for Greening the Financial System. The purpose of the group is to define and promote best practices for green finance. The network has now 87 members, among which all the central banks of the Eurosystem. Recently, the US Federal Reserve became a full member.

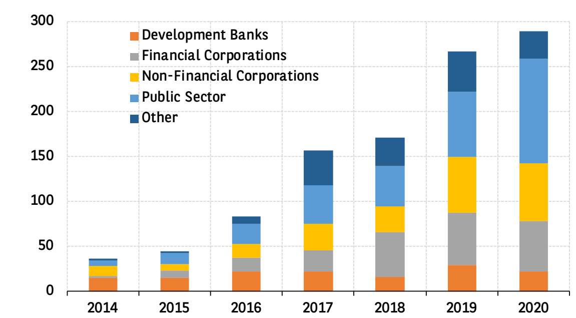
Climate change is also very high on the agenda of the ECB. At her confirmation hearings before the European Parliament in September 2019, Christine Lagarde declared that *"any institution has to actually have climate change risk and protection of the environment at the core of their understanding of their mission"*. One year later, this message was made more concrete when Ms Lagarde announced a review of the monetary strategy, which will also include the implications of climate change for price stability. In the framework of this review, the European central bankers are regularly meeting to discuss climate change. The ECB considers that, based on the EU Treaty, focusing on climate change is an obligation[3]. Its primary objective is to maintain price stability

1. Mark Carney, "Breaking the Tragedy of the Horizon – climate change and financial stability", Speech at Lloyd's of London on 29 September 2015.
2. Climate change and central banking, Keynote speech by Christine Lagarde, President of the ECB, at the ILF conference on Green Banking and Green Central Banking, Frankfurt am Main, 25 January 2021.

GREEN BONDS ISSUANCE BY REGION (USD BN)



GREEN BONDS BY ISSUER TYPE (USD BN)



SOURCE: CLIMATE BOND INITIATIVE, BNP PARIBAS

3. See: "Greening monetary policy", Blog post by Frank Elderson, Member of the Executive

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but without prejudice to this objective *"it shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community as laid down in Article 2."* This article explicitly mentions "sustainable and non-inflationary growth respecting the environment".[4]

As a first concrete step to take climate change into account, the Bank of England, as supervisor of the UK banking sector, will roll out a climate stress test this year. In 2022, the ECB will follow for the banks in the eurozone. Preliminary tests with a 30-year horizon show *"that in the absence of a transition, physical risks in Europe are concentrated unevenly across countries and sectors of the economy."*[5] This clearly would complicate the task of running a monetary policy suitable for the euro area as a whole.

Climate change is not only an issue because of its potential impact on financial and prices stability. By accepting collateral or via asset purchases, the central bank is taking implicitly climate risks on its balance sheet. Bundesbank President Jens Weidmann argues that the ECB should practice what it preaches, and make transparent the climate risk in its portfolio.[6] This implies that the bank should only buy bonds or accept them as collateral for monetary purposes if their issuers meet climate-related reporting requirements. This should have an enormous impact on the disclosure of the carbon contents of financial assets.

The Governor of the Banque de France, François Villeroy de Galhau wants to go further by proposing to decarbonize the corporate assets held on the ECB balance sheet.[7] This brings us to a fundamental question of whether balance sheet risk considerations should determine the standards that are applied or whether -as the third reason why climate change is an issue for a central bank- climate objectives should be pursued in the conduct of its monetary policy. This is a complex matter. There seems to be limited enthusiasm among European central bankers to take climate considerations into account as part of the assets purchase programme, fearing that it might interfere with their mandate.[8] The ECB's primary objective is to achieve price stability. Proponents of a more active role for the ECB argue that it is part of the bank's secondary objective, which is to support the general economic policies of the EU, including promoting environmental sustainability. Such an interpretation could be seen as mission creep, raising questions like how far the ECB should go in pursuing this objective as well as concerns about pressure -from politics or society at large- further down the road to add even more goals. Perhaps, the practical relevance of the debate on monetary policy and climate change is overestimated. Imagine there were strict 'green' criteria for the asset purchase programme, how much of a difference would this make compared to bonds which would not be eligible? Research shows a differential impact of about 15 basis points between bonds that were eligible for the ECB Corporate Sector Purchasing Program versus the non-eligible ones. *"Fifteen basis points is not an altogether negligible reduction, but needs to be seen in the context of a 500 basis point fall in yields since 2008."*[9] To put it differently, the overall market impact is by far more important than the influence on relative prices.

The asset purchase programme is a temporary instrument in the ECB toolkit to reach its inflation objective so eventually, its influence on the pricing of bonds and financial markets more generally will wane, or even go into reverse, when the central bank stops its net asset purchases and, in a second stage, starts shrinking its balance sheet by no longer fully reinvesting the holdings that mature. At the same time, the need to promote the energy transition does not disappear. So other policy levers, which are not in the remit of the central bank, will need to be used.

It is not the ECB's role to take the lead in this area by stimulating green investment and discourage investing in carbon-intensive activities. Government and elected parliaments that have democratic legitimacy are better placed to take decisions in this area.

The new monetary strategy will be announced in September. Environmental campaigners are hoping that the ECB will start greening its assets, but there is room for disappointment given the complexities involved. At a minimum, one would expect the ECB to ask for more disclosure concerning climate-related factors. This could already be an important step forward in improving reporting in this area and lead to more transparency. In that respect, it could make an important contribution in achieving the objectives of the Paris treaty.

Another change could relate to the neutrality principle. This states that asset purchases by central bank should be in line with the issuance volume, so as to avoid favouring bonds with certain characteristics over others. *"However, this interpretation of the principle of market neutrality is increasingly challenged on the ground that it may reinforce market failures that decelerate society's transition to a carbon-neutral economy and may therefore impede, rather than favour, an efficient allocation of resources."*[10]

"The concept of neutrality need not be one of aligning the bought portfolio with market shares. Given the secondary mandate to support other aspects of public policy, a clear societal preference for an alternative formula should be accommodated by the central bank, provided it is not so restrictive as to hamper the success of the primary policy goal. The practical problem for most central banks is to identify such a formula."[11] The EU Treaty and the 'ECB listens' initiative could help the ECB is defining its policy.

There is a certain analogy with economic policy to promote structural change: it should increase the effectiveness of monetary policy, which is why Mario Draghi used to conclude his press conferences by insisting on the necessity of making progress in this area. It is not different with respect to climate change where an appropriate and ambitious policy should have a similar effect.

William De Vijlder and Raymond Van der Putten

Board of the ECB, 13 February 2021

4. Source: Treaty on European Union, Official Journal of the European Communities, 92/C 191/01

5. Climate change and central banking, Keynote speech by Christine Lagarde, President of the ECB, at the ILF conference on Green Banking and Green Central Banking, Frankfurt am Main, 25 January 2021.

6. Jens Weidmann, "Combatting climate change – What central banks can and cannot do", Speech at the European Banking Congress on 20 November 2020.

7. François Villeroy de Galhau, "The role of central banks in the greening of the economy", Speech at the 5th edition of the rencontres on "Climate Change and Sustainable Finance" on 11 February 2021.

8. Martin Arnold, "ECB set to disappoint campaigners on climate change", Financial Times, 21 February 2021.

9. Patrick Honohan, "Should Monetary Policy Take Inequality and Climate Change into Account?", Council on Economic Policies, discussion note 2020/3. October 2019, Peterson Institute for International Economics working paper 19-18

10. From green neglect to green dominance? Intervention by Isabel Schnabel, Member of the Executive Board of the ECB, at the "Greening Monetary Policy – Central Banking and Climate Change" online seminar, organised as part of the "Cleveland Fed Conversations on Central Banking", 3 March 2021

11. Patrick Honohan, ***op. cit.***