On the Role of Central Banks in Enhancing Green Finance

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Overview

- Why should central banks (CBs) care about climate change and other environmental challenges?
- The limits to an environmental role of CBs
- What do CB mandates tell us?
- CBs as socially responsible investors?
- Conclusions

Why should CBs care about climate change and other environmental challenges?

Distinction between…

1) CBs' responses to environmental externalities affecting their traditional core responsibility of safeguarding macroeconomic and financial stability
   – CBs may need to incorporate environmental factors into existing frameworks, for instance into macro-prudential frameworks, without pursuing a "sustainability agenda"
2) Activist role of CBs in "greening" the economy
   – CBs may be mandated to actively use the tools at their disposal to promote green investment or discourage brown investment and play a "developmental role"

The financial & macroeconomic risk argument

- Climate change may have direct consequences for price stability
  - Potential impact on food and energy prices or employment in crucial sectors (agriculture, natural resources)
  - McKibbin et al. (2017): different climate policy regimes – e.g., carbon taxes, permit trading systems – could affect different monetary policy regimes
- Climate and environmental risk constitute a significant systemic risk for the financial sector
  - Transitional risk
  - Physical risk
  - Liability risk
    - CBs need to consider ESG risks when managing their own portfolios

Correcting market failures

- Correcting credit market failures
  - The provision of credit to socially undesirable activities – such as carbon intensive businesses – can be characterised as a credit market failure
  - Green financial regulation as an application of the theory of the second best
- Developing missing markets
  - E.g., green bond markets
    - Reserve management according to SRI principles could help market development

CBs as credible and powerful actors

- CBs are usually among the most powerful public institutions
  - Have high convening power in financial markets
    - “Leading by example”
- Historically, the CBs of most countries have played a crucial role in economic development by supporting targeted sectors, be it in industry or finance
- “Activist” role of CBs in greening the financial system is controversial

Potential policy tools to impact on investment decisions & the creation and allocation of credit

- Green macro-prudential regulation
- Green finance frameworks
- Information disclosure requirements
- Listing requirements
- Sustainable & responsible CB reserve management
- Green credit guidelines
- Directed green credit policy instruments
- Green differentiated reserve requirements or capital requirements
- Green quantitative easing
- Accepting carbon certificates as part of commercial banks' legal reserves
- Convening power
- …

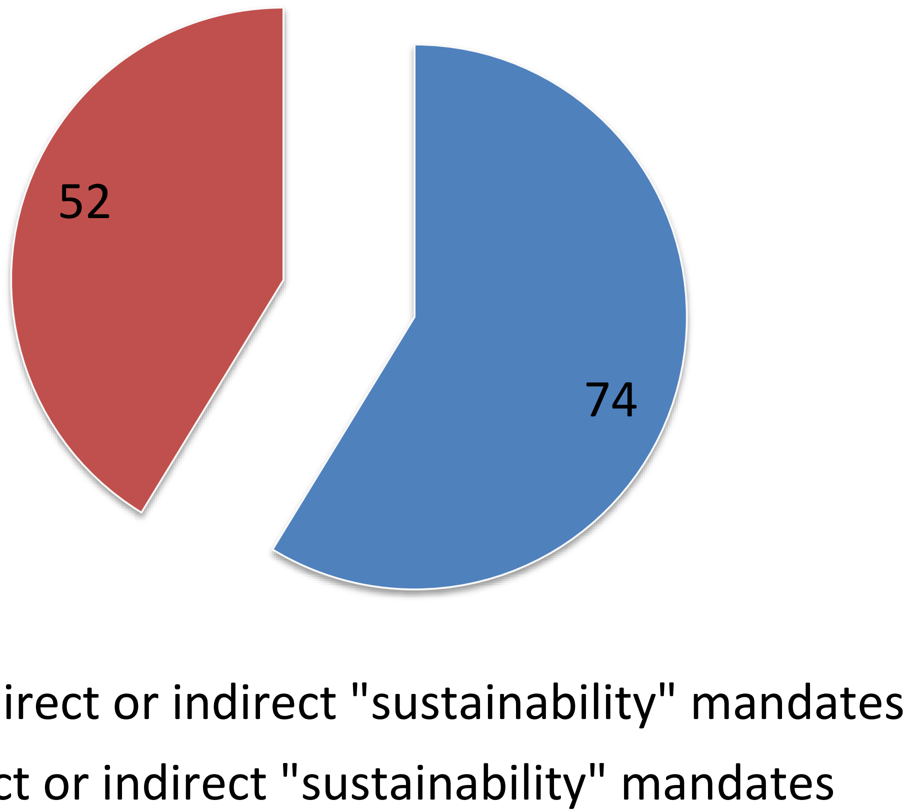
The limits to an environmental role of CBs

- On a functional level, CBs will encounter problems if they are supposed to achieve too many objectives and have too few tools / policy instruments
  - Tinbergen rule
  - Conflicts with other objectives?
  - CBs need to be equipped with effective instruments in order to achieve sustainability goals without compromising other goals
- Danger of vesting too much power in unaccountable institutions
- CBs becoming politicised
  - "Neutrality" of central banking may be at risk
- Overstretching mandates

What do CB mandates tell us?

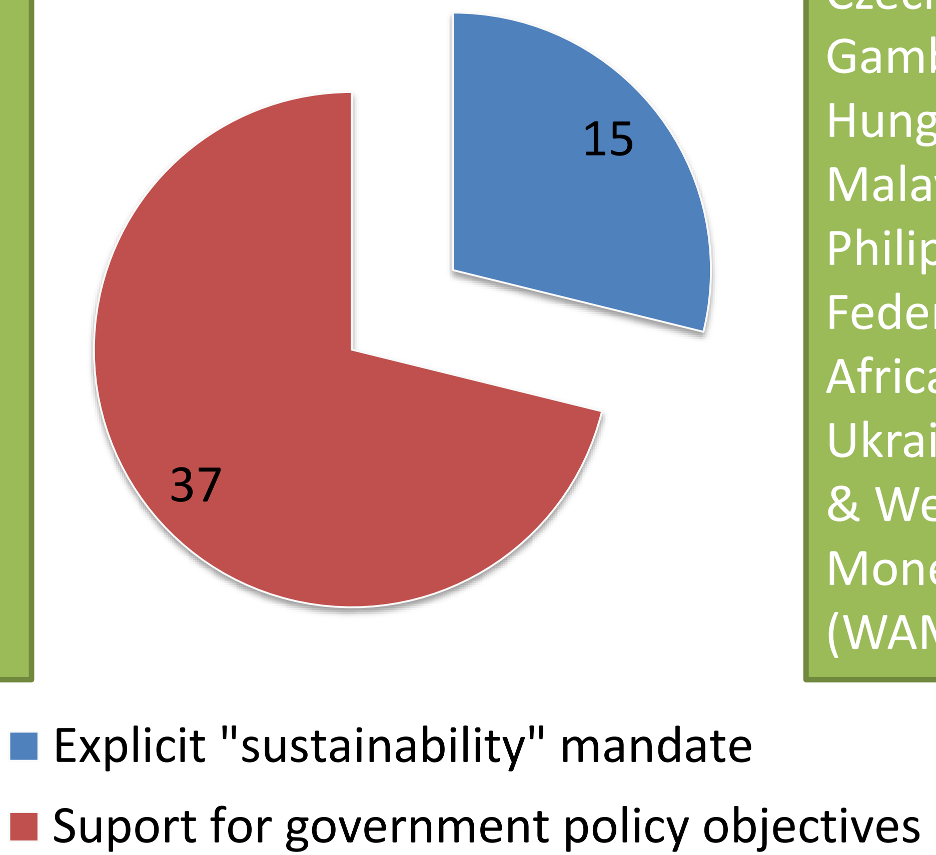
- To what extent do CB mandates currently include objectives that task them to enhance sustainability and mainstream green finance?
- To this end, Dikau & Volz (2018) examine the IMF Central Bank Legislation Database
  - Covers mandates of 123 CBs and 3 monetary unions
- We identified mandates assigning CBs an objective to either
  1) enhance, promote or support “sustainability” or “sustainable development/growth”, or
  2) support the government’s economic objectives or policy goals
     - CBs with this second objective are included because governments’ economic policy goals may comprise sustainability
- CBs with an objective to promote “sustained” growth or development are not considered to have a sustainability-enhancing mandate

Number of CBs with and without “sustainability” mandates



Number of CBs with explicit and potential "sustainability" objectives

"Sustainability" objective is in almost all cases subject to not impeding the CB's ability to pursue the primary objective, which usually is price stability



Czech Republic, Fiji, Gambia, Georgia, Hungary, Iraq, Malaysia, Nepal, Philippines, Russian Federation, South Africa, Tanzania, Ukraine, Zimbabwe & West African Monetary Union (WAMU)

Example: European System of Central Banks

- Article 127 (1) of the Treaty on the Functioning of the European Union clearly defines price stability as the primary objective of the ESCB
- It also states that "[w]ithout prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union."
- Article 3 (3) of the Treaty on European Union includes the objective of "sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress, and a high level of protection and *improvement of the quality of the environment*"
- This means that the ESCB's mandate includes, inter alia and without prejudice to the objective of price stability, supporting the European Union's environmental objectives
- This opens up the question to what extent the political authorities and the public at large want the ESCB to play an active role in supporting environmental objectives
  - In December 2017, the European Parliament passed a resolution calling on all public and private institutions to divest from fossil fuels
- As the current discussions in the Eurozone show, it is not solely up to the CB to interpret its mandate – ultimately, CB policies need to be based on public and political support

- A growing number of CBs has started to incorporate ESG risks into their operations even in the absence of explicit sustainability mandates in order to be able to efficiently achieve their core price and financial stability core objectives
- CB activities depend in practice not only on the formal mandate but also its interpretation, which can be ambiguous

CBs as socially responsible investors?

- Sheng (2014: 17): "[i]f central banks were to join the UN Principles on Responsible Investing, then another US$24 trillion worth of funds would be added to the US$45 trillion already pledged, equivalent to one quarter of global financial assets. 4% of central bank assets allocated to such funding would amount to US$1 trillion alone."

Possible drawbacks of SRI for CBs?

- Outside of mandate?
  - Taking into account ESG risks is prudent
  - SRI is increasing becoming market practice, adopted by commercial investors and public investment funds
- Low returns?
  - OMFIF Global Public Investor 2018 report: divestments and decarbonisation strategies may be financially costly
  - Mixed evidence, depending on time horizon
- Lack of investable assets?
  - Chicken and egg problem?
- Complexity (OMFIF 2018)
  - Lack of international standardisation

Conclusions

- To the extent that CBs are responsible for financial and macroprudential stability, incorporating ESG risk considerations into existing monetary and macroprudential frameworks is already part of existing core mandates
- No convincing reasons against adapting SRI principles for reserve management, but valid reasons for doing so:
  - Need to address ESG risks when managing own portfolio
  - Leading by example – important signaling effect
  - Reserve management according to SRI principles could help green market development
- Whether CBs should also play a promotional role to support green investment is fundamentally a political question that requires careful consideration
  - Limits to environmental role need to be taken seriously

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