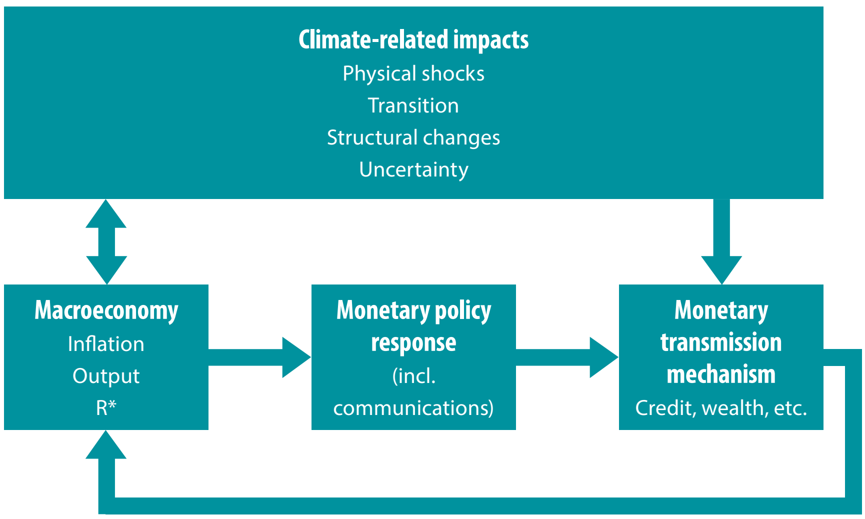
Climate change and monetary policy strategy: a guide for central banks

NGFS
Central Banks and Supervisors Network for Greening the Financial System

Key messages

- Climate change and the transition to net zero emissions are reshaping the macroeconomy and can create trade-offs for monetary policymakers between stabilising inflation and output.
- Some features of climate shocks can make them particularly challenging for monetary policymakers, including their effects on salient household goods prices like food and energy.
- Although monetary policy can often "look through" the short-term impacts of acute physical shocks, this is harder for repeated, chronic or very severe shocks.
- The implications of transition policies for monetary policy depend on the design decisions made by governments.
- Climate change and the transition can also affect the monetary transmission mechanism, the natural rate of interest and the degree of uncertainty facing policymakers.
- Clear communications are essential for central banks as they respond to climate change and the transition.

Climate-related impacts have direct and indirect implications for monetary policy



Find out more in the full report

Implications for monetary policy vary by shock and jurisdiction

Mauritius
Tropical Cyclone Belal in early 2024 increased inflation by ~2.3pp, but the **Bank of Mauritius chose to "look through"** – based on softer measures of core inflation. Inflation fell back to target over the following year, and the recovery was supported by fiscal policy.

Pakistan
Unprecedented flooding in 2022 affected around 33 million people, against a backdrop of broader economic stress. Headline inflation increased to 29.2 %. In response the **State Bank of Pakistan raised the policy rate to 22%**. Inflation fell back to 4.5% the following year.

Step-by-step process for central banks as they respond to climate-related shocks

Steps

1. **Identify the shock**
2. **Assess the propagation of the shock**
3. **Assess whether a monetary policy trade-off arises**
4. **Set monetary policy & communicate decision**
5. **Monitor & reassess**

Shock-specific factors

- Magnitude
- Duration
- Predictability
- Sectoral centrality
- Location
- Origin
- Salience of affected prices for households

Broader factors

Institutional factors

- Central bank remit
- Weight of inflation and output in policymakers' reaction function
- Longer-term impacts of monetary policy

Cyclical factors

- Level of inflation and inflation xpectations
- Business cycle position
- Slope of the Phillips curve
- Fiscal response
- Uncertainty

Structural factors

- Economic structure and stage of development
- Insurance penetration and depth of financial system
- Monetary transmission mechanism
- Resilience and adaptation

Other impacts

Monetary transmission mechanism
Climate shocks can damage collateral, raise credit risk, and tighten lending conditions, weakening or distorting transmission channels.

R* (natural rate of interest)
Most models find that climate change puts downward pressure on R* in the near term, although large-scale green investment may increase it over time.

Uncertainty
Climate-related uncertainty, including around inflation persistence, may require more (or less) active policy to keep inflation expectations anchored.

Communications
Clear communications will be essential for central banks as they respond to climate change and the transition.

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