Sustainable Central Banking

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Why should central banks (and financial supervisors) care about sustainability?
A consensus is building on the need for a proactive role of central banks in addressing sustainability risks

- Environmental problems such as climate change, biodiversity loss, and soil, water and air pollution are threatening human wellbeing and sustainable livelihoods.
- They also pose serious dangers to economic activity and threaten macrofinancial stability – central banks and supervisors have realised that these risks need to be mitigated.
- Socio-economic impacts are also increasingly recognised as important for central banks.
  - Many central banks have secondary mandates on employment.
  - Inequality hampers growth and can cause financial instability.
  - Inequality makes aggregate monetary policy less effective.
From climate risks to financial risks

Climate risks
- Transition risks
  - Policy and regulation
  - Technology development
  - Consumer preferences
- Physical risks
  - Chronic (e.g., temperature, precipitation, agricultural productivity, sea levels)
  - Acute (e.g., heatwaves, floods, cyclones and wildfires)

Economic transmission channels
- Micro
  - Affecting individual businesses and households
- Businesses
  - Property damage and business disruption from severe weather
  - Stranded assets and new capital expenditure due to transition
  - Changing demand and costs
  - Legal liability (from failure to mitigate or adapt)
- Households
  - Loss of income (from weather disruption and health impacts, labour market frictions)
  - Property damage (from severe weather) or restrictions (from low-carbon policies) increasing costs and affecting valuations
- Macro
  - Aggregate impacts on the macroeconomy
  - Capital depreciation and increased investment
  - Shifts in prices (from structural changes, supply shocks)
  - Productivity changes (from severe heat, diversion of investment to mitigation and adaptation, higher risk aversion)
  - Labour market frictions (from physical and transition risks)
  - Socioeconomic changes (from changing consumption patterns, migration, conflict)
  - Other impacts on international trade, government revenues, fiscal space, output, interest rates and exchange rates.

Financial risks
- Credit risk
  - Defaults by businesses and households
  - Collateral depreciation
- Market risk
  - Repricing of equities, fixed income, commodities etc.
- Underwriting risk
  - Increased insured losses
  - Increased insurance gap
- Operational risk
  - Supply chain disruption
  - Forced facility closure
- Liquidity risk
  - Increased demand for liquidity
  - Refinancing risk

Source: NGFS (2020).
Climate risks, macroeconomic variables and challenges for monetary policy

**CLIMATE RISKS**
- Extreme weather events
- Gradual warming
- Transition risks

**IMPACTED VARIABLES***
- Natural rate of interest
- Actual and potential output
- Productivity
- Capital stock
- Balance sheets and financial markets
- Output and inflation
- Inflation expectations
- Relative prices

**CHALLENGES FOR MONETARY POLICY**
- Disentangling temporary vs. permanent shocks and changes in inflation
- Assessing impact on monetary policy transmission
- Communication and credibility challenges due to unpredictability of shocks
- Assessing policy space and actual policy stance

*For impacted variables, the darker the shade, the shorter the time horizon

Source: NGFS (2020).
Physical impacts of climate change already affect price stability in both advanced and developing economies.
Climate change drives up the cost of capital in climate vulnerable countries

• Governments and firms in climate vulnerable countries incur a risk premium on their debt.

• Serious implications for capacity to invest in climate adaptation and resilience, growth & development prospects, and debt sustainability.
What should central banks do?
The broader contours of a new framework for mitigating climate-related and environmental risks and governing sustainable finance is emerging

- Addressing data gaps.
- Enhancing market practices and transparency through standards, taxonomies and disclosure.
- Integrating climate-related and environmental risks into financial stability monitoring and micro- and macroprudential supervision.
- Analysis of climate-related risks through scenario analysis and stress testing.
- Adjusting monetary operations to account for sustainability impacts.
- Integrating sustainability factors into own-portfolio management.
Monetary and prudential measures can be calibrated in a sustainability-enhanced way, taking climate and wider sustainable development factors into account.

**Types of tools in the Toolbox:**

1. **Monetary policy**
   - (1) Collateral frameworks
   - (2) Indirect monetary policy instruments (e.g., reserve requirements)
   - (3) Non-standard instruments (e.g., Asset Purchase Programmes)
   - (4) Direct monetary policy instruments

2. **Prudential policy: Regulation and supervision**
   - (5) Microprudential instruments
   - (6) Macroprudential instruments

3. **Other policies**
   - (7) Further financing schemes and other initiatives
   - (8) Management of central bank portfolios
   - (9) Supporting sustainable finance
As guardians of the financial system, central banks and financial supervisors need to introduce explicit strategies to support the transition to net-zero.

A dual rationale for action:

1. **Macrofinancial stability**: Net-zero is the best way of minimising the risks of climate change to stability of the financial system and the macroeconomy.

2. **Policy coherence**: Ensure that their activities are consistent with government net-zero policy, esp. in countries with a secondary mandate.

Providing clarity, predictability and integrity across the system.
Supporting a just transition by promoting “inclusive green finance”

• The Paris Agreement acknowledges “the imperatives of a just transition of the workforce and the creation of decent work and quality jobs in accordance with nationally defined development priorities”.
  • Social risks threaten a successful transformation to a low-carbon, environmentally sustainable economy.

• While not a panacea, inclusive green finance can play an important role in supporting vulnerable groups in adapting to global environmental change, strengthening their resilience and enabling mitigation of climate change and environmental degradation.

• The financial sector is needed to enable investments in new opportunities for those affected by environmental change.
Highlighting the crucial role that central banks ought to play does not diminish the central role that governments must play in addressing climate change and other sustainability challenges.

- There are many areas where central banks will have to rely on government policies and regulations.

Central banks can play an important role by complementing, catalysing and amplifying governments’ climate policies, but they cannot substitute these.

Thanks for your interest!

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