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Navigating the green transition: Can central banks pick up the slack?

Their role assumes significance not only considering the criticality of climate finance needed for the process, but also to manage the macroeconomic and financial risks ensuing from it. BY BHAVYA GUPTA AND RAMKISHEN S RAJAN

An oil platform in the North Sea, where the UK government is looking to increase oil and gas extraction. As some governments soften their stance over their net-zero promises, central banks have been slowly emerging as key stakeholders in facilitating the green transition. PHOTO: AFP

A RECENTLY released United Nations report reveals stark findings of the planet warming as high as 2.8 degrees Celsius above pre-industrial levels and only a 14 per cent chance of keeping the global temperature rise below the 1.5 deg C target with the current net-zero commitments. Against this backdrop, a flurry of climate news – both good and bad – continues to dominate global headlines.

On the one hand, political leaders are indulging in grand climate proclamations and partnerships to accelerate renewable energy adoption and/or phase out fossil fuels. On the sidelines of the recent Asia-Pacific Economic Cooperation summit in San Francisco, the world's two biggest carbon emitters – China and the United States – announced the Sunnylands Statement on wide-ranging climate cooperation, including agreements to curb methane and nitrous oxide emissions and steps to tackle plastic pollution.

On the other, domestic electoral dynamics and voter discontent with the costly impact of wide-ranging climate ambitions on everyday life have dampened – or in some cases even reversed – policy interventions to achieve the net-zero target by 2050. This has been most evidently on display in several European countries whose governments rolled back or phased down stringent green energy policies imposed on households and businesses in response to growing domestic opposition to these measures.

In the current context of politicisation of governments' net-zero policies and a softening of their stances, central banks have been slowly emerging as key stakeholders in facilitating the green transition. Their role assumes significance not only considering the criticality of climate finance needed for the transition, but also to manage the macroeconomic and financial risks ensuing from this process.

Managing climate-related financial risks

To the extent that climate change has an impact on one of the key mandates of central banks premised on preserving financial stability, their intervention in this area is not anathema. A range of studies has documented how climate disasters coupled with the slow-moving rise in temperatures and sea levels (referred to as physical risk), and the regulatory, technological and behavioural disruptions resulting from the decarbonisation process (called transition risks) can adversely affect the profitability and future cash flows of firms, while posing a systemic threat to the stability of entire financial markets due to the interconnected nature of financial institutions.

Initial anecdotal evidence of climate-related risks to financial stability is emerging from the US, where household insurance markets in at least three states – Florida, California and Louisiana – are confronted with unprecedented losses and rising insurance premiums amid a spurt in hurricanes, floods and wildfires. This has led to private insurers charging customers increasingly higher premiums or even exiting these markets entirely, leaving costly state insurance with low coverage as the only option.

A recent Bank for International Settlements report titled *Too Hot to Insure – Avoiding the Insurability Tipping Point* suggests spillovers to the banking sector and to governments needing to take on the role as "insurers of last resort" if insurance firms exit markets entirely. The insurance market is thus one of several channels through which climate change can materially have an impact on financial stability.

With increased policy attention being paid to the "net-zero by 2050" goal across countries, transition risks have assumed greater significance, particularly with regard to understanding the spillover effects of climate mitigation policies on societies and economic systems.

A major source of transition risk to financial stability arises from an abrupt devaluation of assets in the fossil fuel industry due to increasingly tightened green policies over time, accompanied by a plunge in demand for carbon-intensive energy owing to greener alternatives and increasing consumer climate consciousness. In this context, central banks can undertake policies that encourage the flow of finance to the green transition while ensuring that industries that are most responsible for planet-warming emissions are not made obsolete, leaving their assets "stranded".

On the former, extending concessional financing to green sectors, or green lending, is already a practice in several Asian economies, although it is approached with more caution in Western contexts, where the principle of market neutrality is considered paramount.

Other pro-active central bank interventions include encouraging blended finance to ensure greater private funding towards green sectors by using public sector/multilateral lenders' corpus as a first-tranche risk backstop. The Network for Greening the Financial System, a coalition of over 127 central banks and financial supervisors around the world, is one of the key proponents of this policy. In collaboration with the Monetary Authority of Singapore and the central bank of Netherlands, De Nederlandsche Bank, it announced the planned release of a handbook on blended finance at the COP28 climate summit.

On the latter, an October 2023 Bloomberg article refers to climate-transition funds as being the fastest-growing subcategory of climate funds. However, extending a financial lifeline to high-emitting sectors in the form of transition finance is a thorny issue. Given the surge in popularity of climate-transition funds and the high probability of greenwashing associated with them, regulatory guidance and transparency measures by central banks and financial authorities are paramount to ensure the integrity of these instruments.

Greening monetary policy

As a longer-term goal, central banks will need to account for climate-change and green-transition costs in their monetary policymaking. Climate change is a potential source of risk to inflation in the long term as an increased frequency and intensity of climate disasters pose demand-and-supply-side shocks to output, while rising temperatures and heatwaves contribute to a lowering of labour productivity.

Maintaining price stability is one of the key mandates of central banks, and potential (or long-term) output and labour productivity, which are affected by climate phenomena, are key factors used by central banks in determining their monetary policy stances. One option to tackle inflationary risks from the net-zero transition would be to increase interest rates, pursuing a consistently contractionary monetary policy.

However, this is easier said than done since higher interest rates to combat inflation could also raise financing costs for investing in clean energy and renewables, thus derailing investment in low-carbon technologies. Central banks need to contend with this trade-off and explore innovative policy instruments that can help them maintain higher economy-wide rates while incentivising lower-cost financing to targeted transition-related sectors.

Although "greening" of monetary policy is actively being considered by central banks, it is yet to see widespread uptake. This stems partly from the general criticism of and attack on central banks by elected politicians and commentators, who accuse the institutions of spreading themselves too thin and trying to be "woke" by venturing into climate policymaking.

However, reservation on the part of central bankers themselves arises from the acute uncertainty and unpredictability surrounding the future trajectory of climate change, which makes it significantly harder to incorporate its macroeconomic impacts and channels within workhorse macro models.

Yet, this uncertainty also leads to climate risks being simultaneously underpriced in financial assets, which makes the case for green prudential policies aimed at facilitating the complete price discovery of climate risks even more important. On this front, central banks and financial supervisors can continue doing their part in several ways, including by expecting financial institutions to make more detailed and effective climate disclosures and by developing a "green" taxonomy, which will help combat concerns of greenwashing. Some, like the European Central Bank (ECB), have gone a step further by mandating that only firms that disclose their carbon emissions will be eligible for the ECB's bond-buying programme.

The COP28 summit in Dubai due to begin next week (Nov 30) will feature climate finance, front and centre. As elected policymakers wrangle out concessions while aiming for favourable optics at the high-profile annual summit, central banks can be expected to continue working on enabling regulations and regulatory oversight to align the financial sector with net-zero priorities.

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