Central banks are going green to questionable avail while stirring risks

A loss of autonomy to fight inflation is just one of the dangers.

Finland's forests, which cover more than 70% of the country, are the subject of a continent-wide debate on how to halve EU carbon emissions by 2030. Policymakers, environmentalists, companies and the public are arguing over whether the forests should remain untouched, and thus absorb carbon, or be used as biomaterial.[1]

Environmentalists want the woodlands in Europe's most-forested country to remain pristine carbon 'sinks'. Finland's government, companies, especially the ones that help forestry products generate 20% of the country's exports, and much of the public want to find commercially viable solutions that alleviate warming risks. That an EU proposal released in mid-2021 favoured the carbon-sink option only intensified the debate.

Perhaps the European Central Bank could sort it out? During the dispute over the forests in the euro-member Finland, the ECB declared mitigating climate change was a priority. The central bank said it will embed environmental goals within monetary policy because wild and warmer weather can affect "inflation, output, employment, interest rates, investment and productivity; financial stability; and the transmission of monetary policy".[2]

The Bank of England,[3] the Bank of Japan,[4] the Federal Reserve[5] and Sweden's Riksbank[6] are among central banks to mix sustainability and monetary goals to different extents. They are among the 83-member Central Banks and Supervisors Network for Greening the Financial System that seeks to "mobilise mainstream finance to support the transition toward a sustainable economy".

As part of their green focus, central bankers are calling for net-zero-emissions targets. As they warn of climate systemic risks, central bankers are seeking to use their regulatory powers to enforce climate-risk-based capital standards on banks, conduct climate-change stress tests on financial institutions and force companies to disclose carbon risks. They are under pressure to 'green' the corporate-bond portfolios they have amassed under quantitative-easing programs.[7]

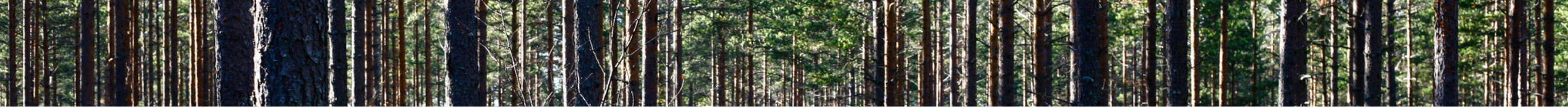
To propel the sustainable shift, governments are appointing climate-aware people to central-bank leadership roles. US President Joe Biden this year, to cite a prominent example, nominated former Fed governor Sarah Raskin to be the Fed's vice chair of supervision of the board of governors.[8] In 2020, Raskin slammed the Fed for giving emergency pandemic relief to "dying" fossil-fuel companies.[9] In 2021, she urged financial regulators to exercise their "existing powers" to mitigate climate change.[10] (Such comments appeared to prompt the Senate in March to block her appointment.)

Many ask whether it's wise for central banks, which style themselves as above politics, to charge into an issue that governments are struggling to solve because, while the science is not contentious, the politics are. Amid such discussions, two questions stand out.

The first is: Will central banks accomplish anything? Those who advocate that central banks consider climate risks say standardising climate-related disclosures and making them mandatory could improve the pricing of climate risks. They say central banks highlighting the long-term financial risks of climate change can only help the public swing behind a solution towards net-zero emissions. They say that central banks can embolden the stability of the financial system over the long term by limiting banking crises caused by a sustained change in weather patterns. Advocates say central banks elevating climate risks would make commercial banks more wary of adding to (and they might even reduce) the US$3.8 trillion major banks have committed to the fossil-fuel industry.[11]

Some factors, however, suggest central banks might achieve less than they hope. First, it can be argued that climate change poses little risk to financial stability. Bushfires, droughts, heat waves, rising and warmer oceans, storms and the like have never in modern times triggered a systemic financial crisis.[12] The industries that lose from the shift to a low-carbon economy (so-called stranded assets) are unlikely to imperil the financial system either. It's usually the next big things that bubble to the point of threatening financial stability.[13] A study of financial crises, This time is different by Carmen Reinhard and Kenneth Rogoff, found one common theme behind eight centuries of financial folly; "excessive debt accumulation".[14]

The second, perhaps surprising, reason central banks might make little headway for the environment is that banks don't appear to have been threatened by climate change and they seem capable of judging such risks for themselves. A 2021 Fed Bank of New York study of declared US disasters from 1995 to 2018 found US banks have learnt to manage climate risks and they gain from calamities. The study found that banks are adept at avoiding loans for, say, homes in harm's way and benefit from lending for rebuilding, "which actually boosts profits at larger



banks". The study noted its findings "are generally consistent" with other studies on bank stability and disasters, even one conducted on banks in the hurricane-prone Caribbean.[15] The results, however, might be different if the world experiences a watershed increase in temperature.

Third, central banks elevating the consideration of climate risks is unlikely to be a telling blow to fossil-fuel companies. If commercial banks were to restrict lending to or increase interest-rate charges for fossil-fuel companies, private financial firms are likely to buy these businesses cheaply, especially in the absence of a price on carbon. The Economist estimates that private equity firms have swooped on US$60 billion of dirty assets in the past two years.[16]

Fourth, central banks have little legal basis on which to act on green lines.[17] Central banks lack authority to direct bank lending. Parliaments could give central banks these capabilities but it's likely such efforts would be as stillborn as most political efforts to mitigate the climate emergency. In the meantime, central banks can only target net-zero emissions – almost indirectly – by using their regulatory powers to highlight financial-stability risks. Last, there appears to be no link between interest-rate settings and a long-term meteorological event. "When it comes to saving the planet, central banks do not have a magic wand," says Jens Weidmann, former head of the Bundesbank (2011-2021).[18]

The other overarching question with central banks going green is: What are the risks? The first is that central-bank climate risk management could clash with their mandates to keep inflation tame over the short and long term. The shift to a net-zero-emissions world stirs what economists call 'greenflation'. This is the term for when fossil-fuel prices jump because investment in climate-harming energy has fallen but demand for dirty power hasn't. Greenflation is already rife in Europe, especially the UK.

The second hazard is that central banks might be adopting an explicit role of capital allocation, which breaches their principle of 'market neutrality'. Their climate stress tests, for example, might force banks to pull back from fossil-fuel assets. They are toying with tilting their asset-buying towards sustainable assets – something a Bank of England paper says defies calibration.[19] While central banks control the quantity of money, the allocation of money is a political choice for governments. Smudge the role of central banks and politicians and central-bank credibility and independence could be lost.

A theoretical risk is that central banks might encourage a green investment bubble on that could metastasise into a systemic threat – think of it as a central-bank 'green put', even if there is no sign of one emerging. A fourth concern is that central banks might be in danger of 'mission creep', at the cost of their focus on inflation. What, for instance, is stopping central banks pursuing other worthy social goals such as reducing inequality (which is made worse by their quantitative easing)?

Setting aside the debate about what central banks might accomplish, the risks show the use of public regulatory powers is a poor substitute for political solutions, even when none are appearing. The problem arising when government institutions step in because politicians can't sort out competing rights is that these bodies become politically tainted. It is best that central banks don't let climate-change priorities get in the way of their traditional tasks, which are hard enough to get right.

To be sure, central banks recognise that governments and parliaments have "primary responsibility" to act on climate change.[20] Central banks certainly have a role in managing the short-term costs of combating climate change, especially greenflation. Government policies to mitigate the climate emergency could hurt the economy to the point of creating financial instability. But that's different from saying changed weather and stranded assets could. Central-bank stress testing demands higher capital requirements for credit cards and auto loans than for home loans or the highest-rated companies. It thus could be argued that central banks are already allocating capital and all they seek to do is extend those responsibilities to mitigating the impact of climate risks on the banking system. Plenty of studies, such as one in 2021 from the US's Financial Stability Oversight Council, warn that climate change poses "an emerging and increasing threat" to financial stability.[21]

What is more certain is the solutions to achieving net-zero emissions need to come from the political process – where they are being thrashed out for Finland's forests.

THE CONFLICT OF INTEREST

UK Prime Minister Boris Johnson this year has faced the threat of a leadership challenge as fellow Conservative MPs (and the public) sickened of endless scandals. These outrages included that Downing Street partied at the height of the pandemic while enforcing strict social restrictions that even prevented relatives being with the dying. They included allegations that Johnson approved the evacuation of zoo animals from Afghanistan while UK nationals were left behind when the Taliban last July took control of the country.

The issue, however, commentators said, shaping as the most damaging blow for Johnson is economic. In February, the energy regulator told UK households their electricity and natural-gas bills could soar 54% come April when regulatory price caps are adjusted for prevailing prices. The average household's annual utility bill is forecast to jump by 700 pounds to about 2,000 pounds.[22]

Energy prices are surging in the UK because the net-zero-emissions Johnson administration has deterred investment in fossil-fuel energies and renewable-energy companies are struggling to produce enough power to make up for the shortfall in climate-damaging-generated power. (One mishap was that an unusual lack of wind failed to power wind farms while Russia's invasion of Ukraine has only added to energy costs.)

The higher power bills come with another blow for UK household budgets. The other battering is higher interest rates. In March, the Bank of England raised its key rate for the third consecutive month. The central bank in March lifted its benchmark rate by 25 basis points to 0.75% because it expects higher energy prices, exacerbated by Russia's invasion of Ukraine, to drive annual inflation above 8% within months. The most recent report shows that steeper energy costs boosted UK inflation to 6.2% in the 12 months to February, a 30-year high and more than triple the Bank of England's 2% inflation ceiling.

This situation encapsulates the greatest quandary for central banks. Policies such as carbon pricing to reduce the production and usage of fossil fuels are likely to boost inflationary pressures (even if it only shows up directly as a one-off jump in inflation gauges). The greatest contribution central banks might make in the quest to mitigate climate change could be to ensure their economies flourish in a low-inflationary way over the longer term, while ensuring financial stability. That would create the most favourable milieu for the political process to tackle climate change, as messy, protracted and contentious as that method might be. See the debate over Finland's forests.

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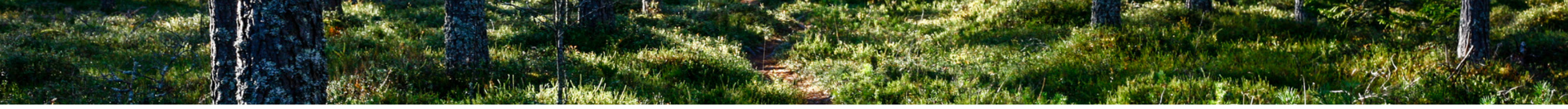

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[4] Bank of Japan. 'Climate change.' boj.or.jp/en/about/climate/index.htm/

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[9] Sarah Raskin. 'Why is the Fed spending so much money on a dying industry?' 28 May 2020. nytimes.com/2020/05/28/opinion/fed-fossil-fuels.html

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[11] World Economic Forum. 'How central banks are tackling climate change risks.' 4 May 2021. weforum.org/agenda/2021/05/central-banks-tackling-climate-change-risks/

[12] SeeJohn Cochrane. 'The fallacy of climate change risk.' Project Syndicate. 21 July 2021. project-syndicate.org/commentary/climate-financial-risk-fallacy-by-john-h-cochrane-2021-07. See also, 'Could climate change trigger a financial crisis?'. 4 September 2021. The Economist. economist.com/finance-and-economics/2021/09/04/could-climate-change-trigger-a-financial-crisis

[13] A problem could arise if climate regulations ensured rapid collapses. But governments would be at fault then, not central bankers.

[14] Carmen Reinhard and Kenneth Rogoff. 'This time is different'. Princeton University Press. 2009. See preface.

[15] Federal Reserve Bank of New York. 'How bad are weather disasters for banks?' November 2021. Revised January 2022. newyorkfed.org/research/staff_reports/sr990

[16] The Economist. 12 February 2022. 'The truth behind dirty assets.' economist.com/leaders/2022/02/12/the-truth-about-dirty-assets

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[18] Jens Weidmann. 'Bundesbank chief: How central banks should address climate change.' Financial Times. 19 November 2020. ft.com/content/ed270eb2-e5f9-4a2a-8987-41df4eb67418

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