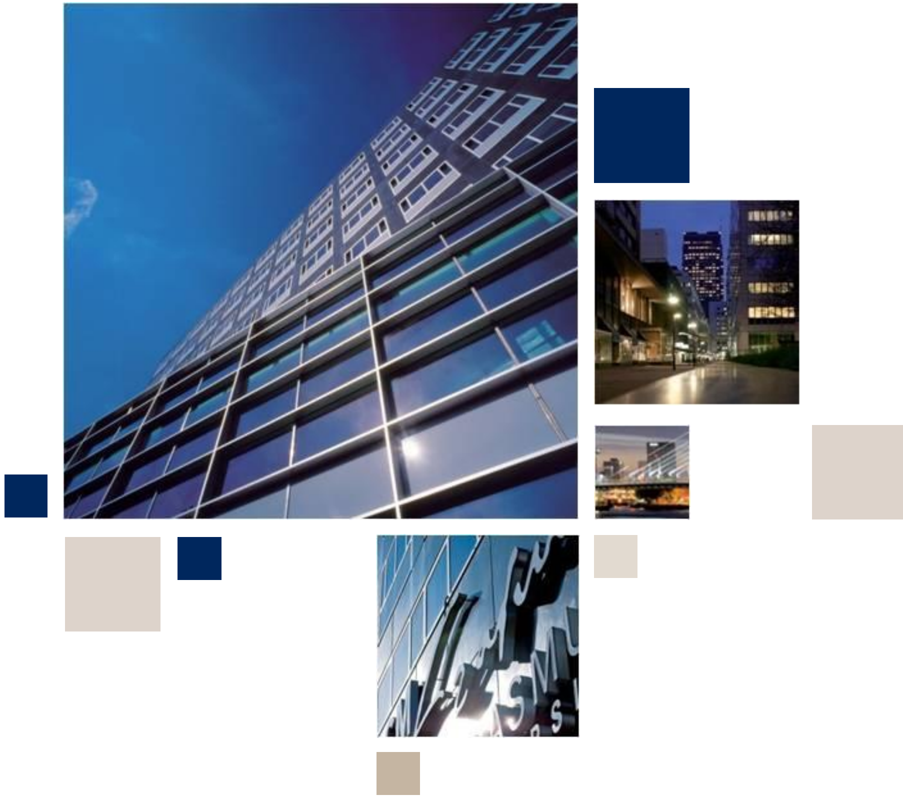
ROTTERDAM SCHOOL OF MANAGEMENT
ERASMUS UNIVERSITY

Greening
Monetary Policy



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NGFS CONFERENCE ‘SCALING UP GREEN FINANCE: THE ROLE OF CENTRAL BANKS’

8 NOVEMBER 2018

RSM - a force for positive change

Agenda

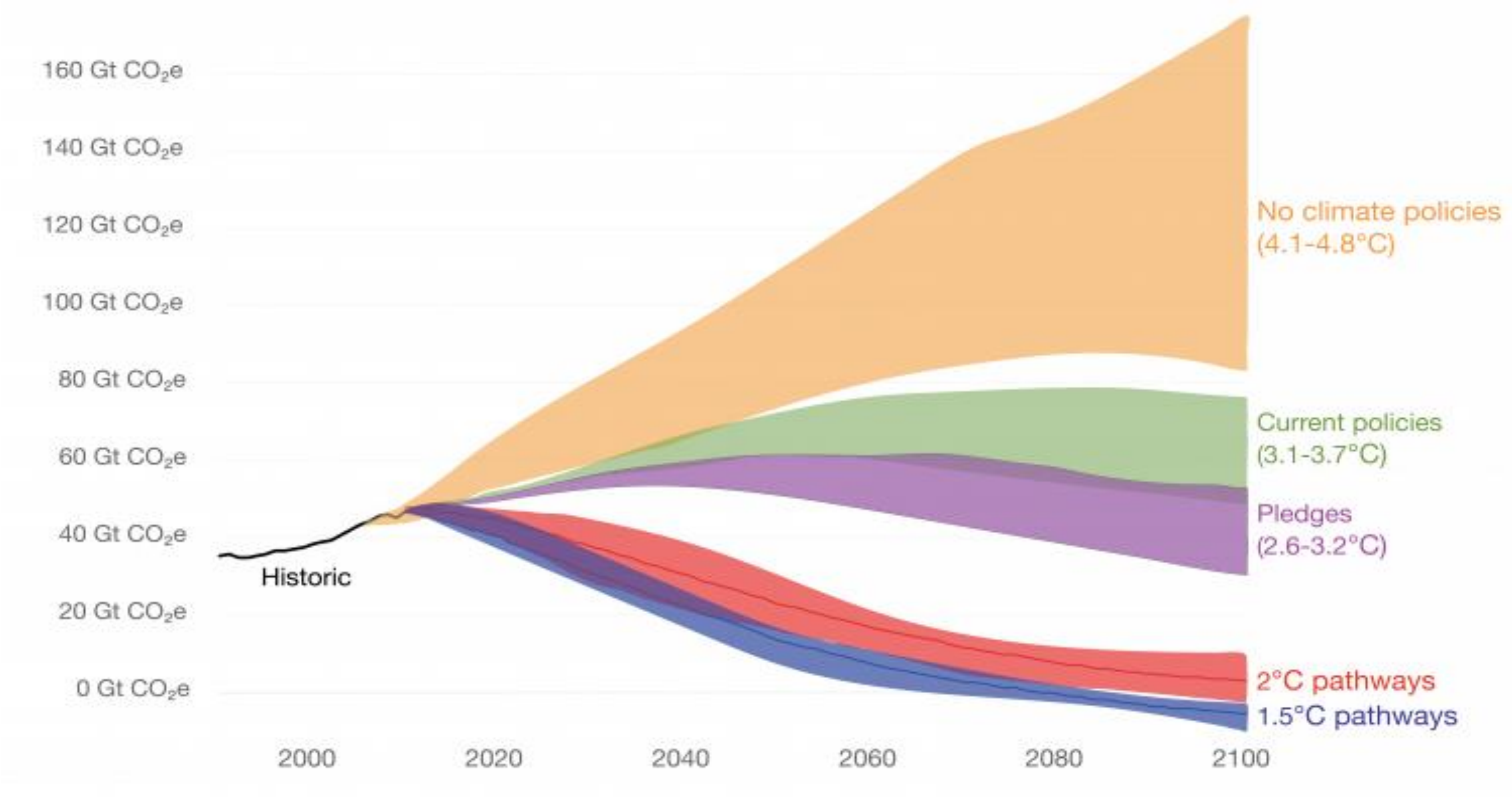
1. Why an issue?

2. Does the central bank mandate allow it?
   - Interpretation of secondary objective

3. How to do it?
   - No interference with price stability
   - Greening operations

4. Concluding reflections

Climate policy gap



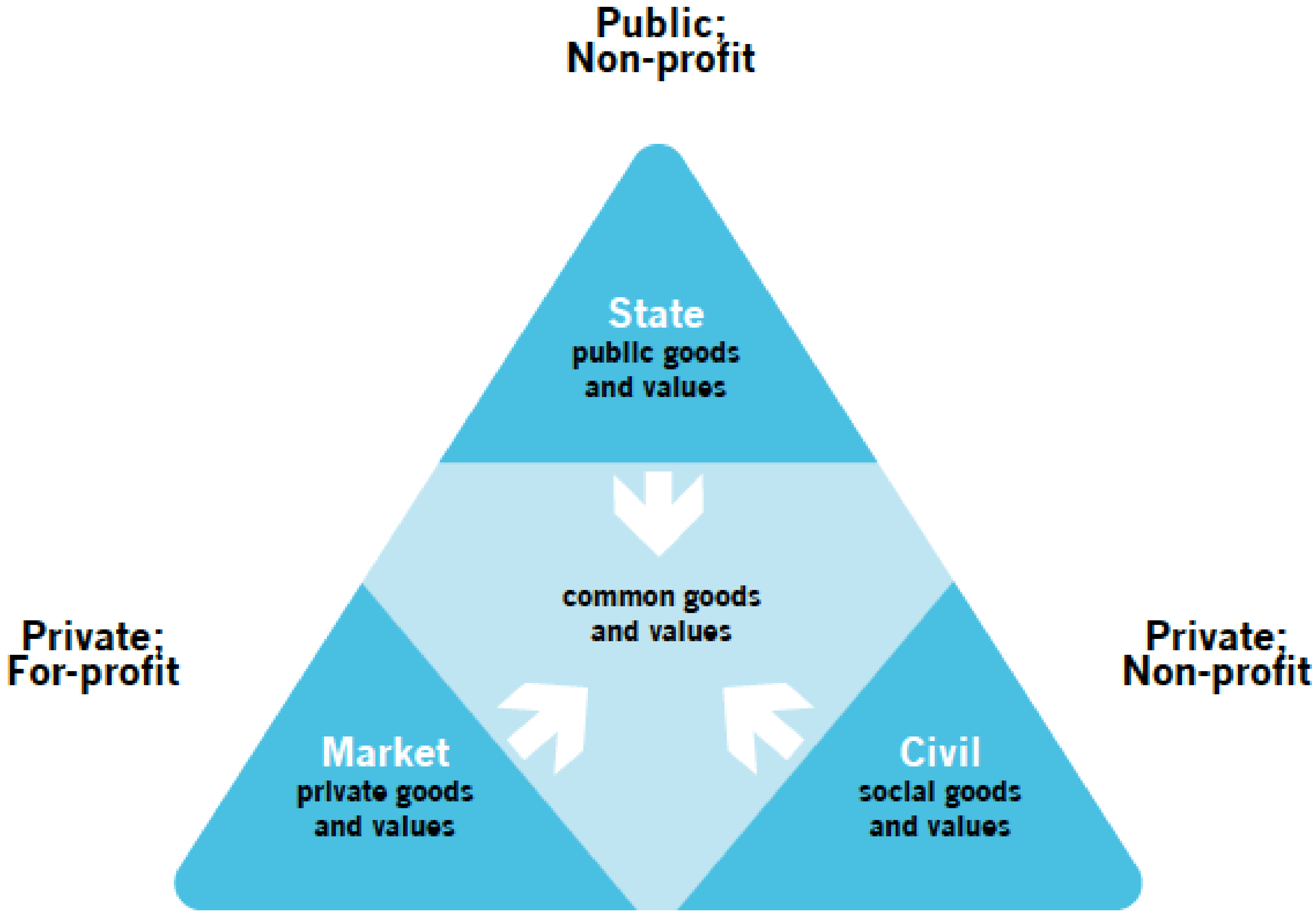
Source: Our World in Data

Climate is on the central bank agenda

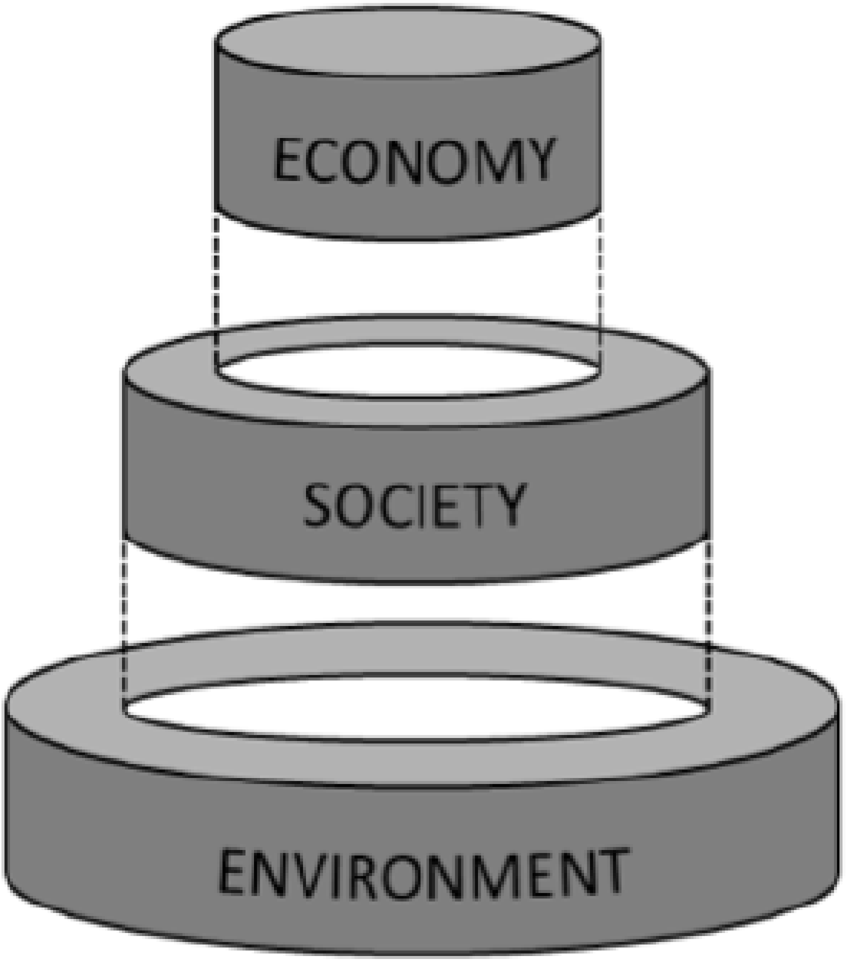
- Natural fit with LT mandate of central banks
  - Fully accepted on financial stability side (Carney speeches; NGFS)
  - But not (yet) on monetary side

- Division of labour between government and central bank
  - Current ideology: CB takes care of price stability and nothing else
  - New emerging view: climate is there for all to act upon
    - Central government, of course, in the lead
    - Other government agencies should contribute where possible

Who should act?



Stiglitz report: sustainable development and growth



→ Impact on economy: GDP

→ Impact on society: Social indicators

→ Impact on environment: Environmental indicators

Legal mandate

Article 127(1) TFEU:

"The primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the <u>general</u> economic policies in the Union with a view to contributing to <u>the achievement of the objectives of the Union</u> as laid down in <u>Article 3 TEU</u>."

Article 3(3) TEU:

"The Union shall establish an internal market. It shall work for the <u>sustainable development</u> of Europe based on balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress, and <u>a high level of protection and improvement of the quality of the environment</u>."

Secondary objective

- ECB (2001): Maintaining price stability is best contribution monetary policy can make to economic policies (growth and employment)

- Bini Smaghi (2007): priority for price stability, because possible trade-offs between price and output stability

- But are there trade-offs between price stability and environmental policies?
  - ➢ If not, then EU Treaties allow Eurosystem to green monetary policies
  - ➢ Even stronger: the Eurosystem should support transition to low carbon economy without prejudice to price stability

Delegation of powers

- Tucker (2018): CB is co-manager of government consolidated balance sheet
  - ➢ How far should unelected technocrat central bankers go?
- Current policy of market neutrality
  - ➢ No interference with price formation in markets
- Should Eurosystem remain market neutral towards carbon intensity assets?
  1. But current policy is carbon intensive (corporate bonds)
  2. Little awareness of carbon risk: price formation does not work properly
  3. This paper proposes <u>general</u> approach towards low carbon assets

No interference with price stability

- Tinbergen rule – one policy objective for each instrument
  - ➢ Stage 1: policy decision is taken (interest rate, currency composition reserves or collateral)
  - ➢ Stage 2: implementation following operational procedures (e.g. eligibility criteria for assets and collateral)

- Two conditions to avoid disruptions in transmission mechanism
  1. No adjustments in asset mix, currency denomination and maturity
  2. Keep list of eligible assets as broad as possible to minimise impact on markets

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Reputation

- Reputation of central bank is build on:
  - Full independence of government
  - Track record on price stability (single mindedness)

- No alternative policy goals, like employment, environment, etc

- Proposal: technical approach towards asset / collateral framework
  - Example: fully accepted that CB have a credit risk policy
  - Similarly, CB can adopt a low carbon policy

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Greening operations

- Support general policies EU: transition to low carbon economy
- Indicator: current and future carbon emissions (scope 1, 2, 3)
- Which <u>general</u> ESG method?
  1. Negative screening (risk avoidance)
  2. Best in class (more opportunity driven towards low carbon)
  3. Portfolio tilt towards low carbon (like 2.)
- Recommendation is 2. or 3. as objective is to move to low carbon economy

Outcome

- Would low carbon bias support the general policies of the EU (speed up transition to low carbon economy)?
  - ➢ Yes, increased eligibility assets or lower haircut collateral generates liquidity premium lowering cost of capital for low carbon companies

- Equilibrium effect
  - ➢ If higher cost of capital > cost of reforming, then reform
  - ➢ Fraction of green investors > 20% needed to induce reform
  - ➢ By greening operations, CB would add to this fraction

SIX CAPITALS, OR CAN ACCOUNTANTS SAVE THE PLANET?

Rethinking Capitalism for the Twenty-First Century

JANE GLEESON-WHITE

Concluding reflections

- Eurosystem should support general policies EU, including transition to low carbon economy

- Technically possible without interference with smooth conduct monetary policy

- But are central bankers prepared to cross the Rubicon?
  - ➢ Other sectors (accountants, investors) have done so after discussions
  - ➢ Central banks could/should also do it and stick to a general approach
  - ➢ Stay away from specific projects / sectoral targets; that is for government

Recommendations

- It is first and foremost about leadership
  - Do central bankers want to pursue a low carbon policy?
  - Get motivation right – opportunity to move to low carbon economy

- Second, take a technical approach on asset / collateral framework
  - Don’t make it a ‘high level’ policy objective
  - But include low carbon in the eligibility criteria, just like credit risk

- Third, follow a general (and proven) approach towards low carbon
  - Avoid endless and personal discussions on what is “good” and “bad”