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CIO Viewpoint

Do central bankers have a climate change mandate?

Investment Solutions

18 November 2019

Hurricanes, typhoons, drought, flooding, heatwaves and wildfires from the Arctic to Australia are set to make 2019 the most disastrous year for extreme weather worldwide in two decades. In addition, the last five years have been the hottest on record. This is also the year that the new heads of the International Monetary Fund and European Central Bank made climate change a priority. The subject, which once looked like a longer-term problem, feels very much here-and-now.

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So the question, "do central bankers have a mandate to tackle climate change?" is becoming much more urgent, and a growing number of policymakers believe they have a part to play in tackling the crisis.

Central banks' mandates tend to focus on the medium term outlook for inflation. However, they also routinely take the policy implications of long-term events, such as longer-term demographic and technological shifts and their impacts on workforces, into account when looking at the broader macro economy. Climate change then poses policymakers with a challenge in terms of how to manage the uncertainty surrounding its repercussions on monetary policy.

Climate change may affect every economic activity and asset prices, especially the cost of food and energy, creating inflationary effects. Put simply, climate change is a risk to financial stability, and so, looks like a central banker's problem.

The debate over whether central banks have a role to play in tackling climate change can be traced to a 2015 "tragedy of the horizon" speech by Bank of England Governor Mark Carney. It is not the job of central bankers to dictate particular policy responses, Mr Carney argued, but they do have "a clear interest in ensuring the financial system is resilient to any transition." The transition, short or long, to a carbon-neutral economy will overturn the value of every asset and the longer an adjustment in the real economy takes, "the greater the risk that there is a sharp adjustment."

ECB, Riksbank, EIB

A number of central banks are making changes to their investments. This year, the European Central Bank formally identified climate change as a key threat to the banking sector. Christine Lagarde, the ECB's new governor, has suggested changing its mandate to meet new challenges, including technology, crypto-currencies, non-financial loans and climate change. She also told the European Parliament last month that she wants to make climate change a priority because it poses "macro-critical risks."

Key takeaways

- Climate change threats are pushing central banks to examine their role in tacking climate change
- Many argue that their mandates to ensure price stability mean they can act
- Climate change is higher priority for the new IMF and ECB heads
- Policymakers have recognised that they cannot wait until assets are impossible to price before acting.

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Weekly publication of Lombard Odier – Contacts: Investment Solutions, investment-solutions@lombardodier.com
Data as of 18 November 2019 unless otherwise stated.

Indeed, on the subject of mandates, Lagarde may plausibly argue that hers comes not from statutes in Frankfurt, but the 2015 Paris agreement that commits the European Union to limiting global warming to "well below 2°C above pre-industrial levels."

Last week the Riksbank announced that it has sold its sub-sovereign debt from coal-producing provinces of Queensland and Western Australia as well as the Canadian province of Alberta, which invests in oil sands extraction. "We will not invest in assets issued by issuers with a large climate footprint," said the Swedish central bank's Deputy Governor Martin Flodén. Because most of the bank's investments are in government paper, he added, green bonds, which usually invest in specific environmental projects, are not an option.

Then on 14 November, the European Investment Bank announced that it would stop financing fossil fuel energy projects, including natural gas, from the end of 2021. The EIB, the largest multilateral financial institution in the world, has more than USD 500 billion in outstanding loans.

Stranded assets

One of the problems for central banks is how to manage "stranded assets," or fossil fuel-related investments that are falling in value. In an economy transitioning to a low-carbon environment, these will become a trillion-dollar drag on central banks' own portfolios, as well as, more importantly for the wider financial markets. For example, the Norwegian central bank has recognised that during a transition phase, lending to the country's oil and gas sector creates a risk.

There is no consensus over how far central banks should go to integrate climate change into their outlooks. Many, however, are working on the problem. The Reserve Bank of India, for example, asks commercial banks to allocate a proportion of their lending to a list of "priority sectors,' which now include renewable energy, and the People's Bank of China has incorporated green financing into its macro-prudential framework. The Banco Central do Brasil has called on commercial lenders to include environmental risk factors into their governance and then show how these affect their capital requirements. Finally, the Bank of Japan's loan support programme offers below-market-rate loans to financial institutions to support sectors including environmental-focused businesses.

Within their own books, the Dutch central bank purchases green bonds and applies Environmental, Social and Governance criteria for example, while the Swiss National Bank applies ethical exclusions to its purchases of foreign assets.

There is no agreement yet how to manage central bank's legacy of carbon-heavy assets, which after all, belong to governments. Germany's central bank is a notable stand-out in the debate. Jens Weidmann, head of the Bundesbank, agrees that central banks have a role to play, but only to manage the devaluation of these "stranded assets". Mr Weidmann does not agree that policymakers should put in place preferences for green assets or discriminate against so-called brown assets. Rather than prefer green bonds, central banks must continue to buy fixed income based on existing market rating criteria, he has argued.

Nevertheless, central banks must deal with the risks of climate change, "that's crystal clear," said Bundesbank executive board member Sabine Mauderer recently. "But they cannot substitute climate policy," she said, which is the job of governments. To manage climate change as a source of financial risk effectively, she added, central banks need more and better data about systemic risk through consistent and standardised disclosure.

Coordinating action

In an effort to manage this data challenge, the Network for Greening the Financial System (NGFS) created in 2017, tries to share best practices and analysis with the goal of helping the financial sector to meet the Paris agreement's ambitions and manage risks through sustainable investments. In April this year, the NGFS published its first recommendations.

The US Federal Reserve is, notably, not part of the NGFS. Governor Jerome Powell, for example, said recently that climate change is not a "near-term" threat. Still, part of the Fed's role, according to Governor Lael Brainard on 8 November, is to adapt to new challenges. "This is no less true for climate change than it was for globalization or the information technology revolution."

The NGFS, in turn, leans on the work of the Task Force on Climate-related Financial Disclosures, which develops standards for the data that businesses need to disclose to markets.

The challenges of climate change may not be as immediately threatening as the financial crisis and its response that started in 2008. However, policymakers have recognised that they cannot wait until financial and insurance markets are no longer able to price risk or assets before addressing the challenges. Central banks must play a role in acting as part of the mechanism through which the global economy can make the transition to a low-carbon economy.

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06.2019