1 February 2023 | Frankfurt meets Paris: how central bankers can help save the climate

Prof. Emanuele Campiglio: Central banks' role in addressing climate change

Central banks can assist societies in fulfilling two societal functions to address climate change. The first function is to improve understanding of the socioeconomic implications of a low-carbon transition through quantitative modelling and data collection on climate-related expectations. Central banks have been and should direct the brainpower of their research departments toward answering climate-related research questions. The second function is to manage climate-related expectations to avoid disruptions. To achieve this, a credible and time-consistent policy maker should set clear schedules for steadily increasing carbon prices. Central banks can play a role in managing expectations, but there needs to be a discussion on an appropriate institutional framework to balance climate action and institutional legitimacy.

Prof. Michael Bauer: Balancing price stability and environmental objectives

The European Central Bank (ECB) is legally obligated to support the EU's environmental objectives based on its secondary mandate. The ECB's significant footprint in financial markets provides European central bankers with substantial leeway to actively support the transition to a low-carbon economy. Three criteria can be used to evaluate monetary policy tools to support this transition: whether the policy aligns with the primary mandate of maintaining price stability, whether it risks endangering the central bank's independence, and whether it has any adverse side effects such as distributional effects, competition effects, or effects on financial stability. The ECB must carefully consider the costs and benefits of monetary policy tools to support the low-carbon economy.

Thekla von Bülow: A comprehensive look on green investment needs

To accomplish the green transformation, European businesses must channel huge investments towards green technologies and the transformation of their operations. A sizeable portion of these investments will need to be made by small and medium-sized enterprises (SMEs) and midcaps who typically fund their projects with bank loans. The recent substantial increase in interest rates has caused an overall slowdown in green investments in Europe. In this environment, the public sector should apply policy instruments that secure revenue flows and hence instill investor confidence in green projects, such as subsidies or insurance schemes. The public sector and the ECB must coordinate policies and regulations to ensure that all relevant actors in the market are assisted in the transition to green. Policy makers should not overlook SMEs and midcaps who often lack the required capital and credit rating to realize green investments.

Three insights from the discussion with the audience

- The impact of inflation on the green transition depends on the type of inflation, with "fossilflation" potentially being beneficial due to triggering mechanisms for substitution towards low-carbon technologies. However, other forms of inflation, such as "greenflation", could be detrimental to the green transition. The ECB's first mandate of achieving price stability will support the green transition in the medium term by creating a precondition for strong investment growth, which is necessary for decarbonizing the economy.
- The ECB is taking steps towards fostering green investments, for example by purchasing green assets, but faces various limitations. It is particularly challenging to green the ECB's sovereign bond portfolio. Purchasing green bonds from supranational bodies such as the European Investment Bank could help, but based on these bodies' current statutes their ability to raise capital by issuing additional green bonds is limited. The ECB is pushing the boundaries of what can be done within the current institutional framework, but to further boost its role, the institutional framework would need to be adapted.
- To adapt the institutional framework and to avoid burdening conventional central banks, a new body ("Climate Systemic Risk Board") could be established and tasked to set stable carbon prices. The European Systemic Risk Board serves as an illustration of an entity that shares a comparable institutional framework.