**Why two degrees matter to central banks**

*By Ulrich Volz*

*Central banks ought to address climate risk as part of their mandate. Strong leadership is required from central banks and supervisors to make sure the financial sector will be in a position to weather the storm and contribute to an adaptation of our economies to the new climate reality.*

The increasing public awareness of the perils of climate change and the political commitment of the international community to address these challenges embodied in the Paris Agreement have, over recent years, led to an intensifying discussion on the role of central banks in addressing risks associated with climate change and in supporting the development of green finance. This has not been a purely theoretical debate.

A growing number of central banks as well as supervisors have already adopted green finance policies or guidelines, or have started to incorporate climate risk into macroprudential frameworks. This has given rise to the launch of initiatives such as the Sustainable Banking Network – a community of financial sector regulatory agencies and banking associations from developing and emerging markets committed to advancing sustainable finance in line with international good practice – and the Central Banks and Supervisors Network for Greening the Financial System (NGFS). The latter was launched in November 2018 as a “coalition of the willing” after the G20 Sustainable Finance Study Group faltered due to the United States government’s hostility against anything related to climate change mitigation and adaptation. The NGFS, has grown from eight founding members to a grouping which now comprises more than 40 members and observers.

**A call for action from central banks and supervisors**

This month, the NGFS published a progress report called *A Call for Action*. The report highlights climate change as a source of structural change in the economy and financial system, and asserts it therefore falls squarely within the mandate of central banks and supervisors to deal with its consequences.

The NGFS report issues six recommendations to the central banking and supervisory community:

1. to integrate climate-related risks into financial stability monitoring and micro-supervision;
2. to integrate sustainability factors into their own-portfolio management;
3. to bridge the data gaps and make available data of relevance to climate risk assessment;
4. to build in-house capacity and to collaborate within their institutions, with each other and with wider stakeholders to improve their understanding of how climate-related factors translate into financial risks and opportunities, and encourage technical assistance and knowledge sharing;
5. to support for the recommendations of the Task Force on Climate-related Financial Disclosures; and
6. to support the development of a taxonomy that enhances the transparency around which economic activities contribute to the transition to a green and low-carbon economy, and those that are more exposed to climate and environment-related risks.

The NGFS report, and the fact all institutions involved were able to agree on these recommendations, is remarkable and a reflection of how the discourse has changed in a relatively short space of time. When Bank of England Governor Mark Carney gave his now famous speech on the *Tragedy of Horizons* at Lloyd’s of London in 2015, in which he highlighted the need for supervisors to address financial stability risks related to climate change, he received a lot of sceptic responses and accusations of mission creep.

I experienced this scepticism myself. When I started a research project on climate risk and green finance with the Indonesian central bank almost a decade ago, my friends and colleagues at central banks were flabbergasted why a central bank should be interested in such a topic. When I wrote and presented a paper in 2014 on the role of central banks in greening the financial system, in which I highlighted how climate-related risk can impact on macroeconomic and financial stability, and argued that central banks and supervisors had a role to play in addressing this, the standard response I received was that central banks were already overburdened with other tasks and that this was simply not their job.

**What do central bank mandates say?**

The times when central bankers would risk their reputation when raising climate issues are over. A general consensus is emerging – as reflected in the NGFS report – that central banks and other supervisory bodies cannot ignore climate change. The impending climate crisis, which will have a potentially disastrous impact on our economies and requires urgent policy action, is undoubtedly changing the policy environment in which central banks are operating.

Climate change has possibly significant implications not only for the core operations of central banks but also poses the question of their broader role in addressing climate change-related risk and mitigation. However, there is no agreement on the extent to which climate change (or other environmental risks) should be incorporated into existing operational frameworks or whether central banks should even play a supportive or promotional role in scaling up green finance. This may not be surprising, given the different histories and policy traditions of central banks in different parts of the world and also given the differences in their mandates.

How far central banks can go in playing a role as an overall catalyst for mainstreaming green finance on the one hand, and incorporating climate risks in their core policy frameworks on the other hand, depends significantly on their mandates. A close investigation of the legal objectives of central banks is therefore essential in order to substantiate the on-going discussion against the background of the increasingly pressing issue of responding to global warming. In a recent study prepared for a NGFS conference on the role of central banks in scaling up green finance hosted by the Bundesbank – a central bank renowned and respected for its conservative credentials – I investigated together with Simon Dikau to what extent climate-related risks and mitigation policies fit into the current set of central bank mandates and objectives. To this end, we conducted a detailed analysis of central bank mandates and objectives, using the International Monetary Fund’s Central Bank Legislation Database, and compared these to current arrangements and sustainability responsibilities that central banks have adopted in practice.

Our analysis of 133 central bank mandates shows only 16 of the investigated central banks and monetary unions operate under a mandate which explicitly includes the promotion of sustainable growth or development as an objective. However, a further 38 central banks are tasked to support their governments’ national policy objectives, which, thanks to the Paris agreement and the United Nations’ Sustainable Development Goals, should almost universally comprise sustainability. This means 54 central banks or 41% of our sample are mandated to either enhance the sustainability of growth and development or to support their government’s potential sustainability policy objectives. This is usually conditioned on not interfering with achieving their primary objective, which typically includes price stability.

However, our analysis also shows how climate risks may directly impact on traditional core responsibilities of central banks, most notably price and financial stability. The implication is that central banks will have to incorporate climate- and mitigation-risks into their core policy implementation frameworks in order to efficiently and successfully safeguard price and financial stability, even if their mandates make no explicit or implicit reference to sustainability. Not all central banks which have joined the NGFS have an explicit or implicit sustainability objective in their mandate. However, they have all accepted climate change risks are a source of financial risk and have hence concluded that ensuring the financial system’s resilience towards these risks lies within their mandates.

A potential role of central banks in promoting sustainability in the financial system and “greening” the economy is more contentious, not least because of the possibility of distorting effects that direct interventions into the market aimed at “greening” the economy might have, but also due to potential conflicts with the central bank’s primary goals. It therefore is essential a potential supporting role of central banks is covered by their mandates. The fact central banks have a potentially large number of instruments to affect the allocation of capital towards green investment, does not necessarily imply they should be tasked to do everything they possibly could. Starting with existing central bank mandates – which differ across countries/monetary areas – and also taking into consideration different central banking traditions, a discussion is needed about the extent to which central banks should support their respective government’s sustainability policies.

**The Eurozone: 2 degrees, not only 2 percent**

The European Central Bank and the European System of Central Banks (ESCB) provide a good example of climate change mitigation being a secondary goal. For the Eurozone, Article 127 (1) of the Treaty on the Functioning of the European Union clearly defines price stability as the primary objective of the ESCB. However, it also states that “[w]ithout prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union.” Article 3 (3) of the Treaty on European Union in turn includes the objective of “sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress, and a high level of protection and *improvement of the quality of the environment*”. This implies the ESCB’s mandate does indeed include, inter alia and without prejudice to the objective of price stability, supporting the European Union’s environmental objectives. This gives rise to the question to what extent the political authorities and the public at large want the ESCB to play an active role in supporting environmental objectives. As the discussions in the Eurozone in the course of the euro crisis showed, it is not solely up to the central bank to interpret its mandate – ultimately, central bank policies need to be based on public and political support.

Benoît Cœuré, a member of the Executive Board of the ECB, recently addressed the underlying question of whether environmental issues are part of the ECB’s mandate, arguing that while the Treaty mandates the protection and improvement of the quality of the environment, it also opens up the question of “why the ECB should not promote industries that promise the strongest employment growth, irrespective of their ecological footprint”, thereby pointing to potentially conflicting objectives outside of the ECB’s core functions. On the issue of how climate change affects the conduct of monetary policy, Cœuré reasons it may “complicate the correct identification of shocks relevant for the medium-term inflation outlook, … increase the likelihood of extreme events and hence erode central banks’ conventional policy space more often, and … raise the number of occasions on which central banks face a trade-off forcing them to prioritise stable prices over output”.

However, Cœuré argues generally “there is scope for central banks themselves to play a supporting role in mitigating the risks associated with climate change while staying within [their] mandate”. Furthermore, with regard to the threat of material climate-related risks, the ECB states that while it does not see that these risks pose a threat in the short-term for financial stability in the euro area, banks may be indirectly but substantially affected by “more frequent and severe extreme weather events or by the ongoing transition to a low-carbon economy”.

**Central banking below the sea level**

The case of the De Nederlandsche Bank’s mandate and objectives offers further insights into the complexity of assessing a central bank’s “green” role based on its legal objectives. As part of the ESCB, the DNB’s objectives and tasks are determined by the same provisions of the Treaty which determine the mandates of all national EU central banks, namely, price stability, support for the general economic policies in the EU and to act in accordance with open market principles. Despite the absence of “sustainability” from its statutory act, today the DNB is credited for having formally integrated sustainability into its operational framework. This was due to a deliberate decision in 2011 by the then newly-appointed board of the DNB to update the central bank’s mission statement at the time.

Against the background of the 2008 crisis, financial stability was considered by the DNB’s board to be a necessary central pillar of its mission statement in order to differentiate the new approach from the pre-crisis one, the latter of which had proved to create “prosperity [that] had turned out not to be sustainable”. The DNB’s mission statement, both as a central bank and financial supervisor, since 2011 hence requires the DNB “to safeguard financial stability and thus contribute to sustainable prosperity in the Netherlands”. At the time, the term “sustainability” did not necessarily have the same connotation that it has today with regard to climate change and greening of financial systems. Nonetheless, this has led the DNB to incorporate sustainability considerations in most of its core operations, including in economic research. Furthermore, the DNB recognises the necessity to contribute to sustainable development. While Frank Elderson, the DNB executive director (and also chairman of the NGFS) is careful to emphasise “as a central bank and supervisor, we must not overstretch our mandate”, he has also emphasised the DNB does consider ways to “impact investment decisions and credit allocation” and help “transform the financial infrastructure” to take into account the transition to a low carbon economy to fall under its mission of “safeguarding sustainable prosperity”.

**The Green Lady of Threadneedle Street**

The Bank of England is an example of a central bank which has no explicit reference to sustainability in its mandate, although it is (at least for the time being) a member of the ESCB and as such bound by the same provisions of the Treaty as all other central banks of EU member countries. The Bank’s pro-active stance towards addressing climate-risks has been condemned by a few of being part of the bank’s “mission creep” of offering warnings on topics some consider too political for the institution. However, the BoE’s mandate obliges it to support the government’s economic policy and objectives for growth, which are set out in the Treasury’s Annual Remit for the Monetary Policy Committee. The latest remit explicitly and repeatedly sets out “sustainable and balanced growth” as the government’s economic policy objective. It could therefore be argued the BoE is thereby also furnished with an indirect sustainability objective through supporting the government’s sustainable economic growth policy.

Carney strongly maintains the BoE considers it a central part of its responsibility to identify, warn against and mitigate any kind of threat to financial stability, including those from climate change-related risks. With regard to the BoE’s approach to mitigating climate risks or greening the financial system, Carney has voiced his distaste for a “surreptitious” approach or implicit guidance through central bank soft power and “against lowering capital requirements for a bank if they invest in a green project per se”. Instead, Carney expressed support for explicit climate change-related regulation or carbon pricing. Regarding a “promotional” role in enhancing green climate policy, Carney points to the limits of the mandated role of central banks, which, he maintains, cannot “substitute for governments in climate policy”.

**From theory to practice**

Now the responsibility of central banks to mitigate climate risks is increasingly becoming accepted, attention is shifting to the question how central banks should operationalise this. There are no easy answers, but the recent NGFS recommendations mentioned above are a good starting point. Central banks need to step up efforts to further enhance their models to include climate risks and set out a set of transition scenarios to help simplify the analytical challenge, not only for themselves but also for the financial institutions they are supervising. Developing scenario analysis, including orderly and unorderly scenarios, and stress tests will help to highlight where action is most urgently needed.

Certainly, more data is needed for developing a better grounded, more granular and holistic view of the risks we face. Yet given the great urgency in addressing climate risks, it will be more important for central banks to be roughly right now than to be precisely right later. Waiting for financial markets to address climate risks by themselves would be foolish. Strong leadership is needed by central banks and supervisors to make sure the financial sector will be in a position to weather the storm and contribute to an adaptation of our economies to the new climate reality.

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