Show the Climate Change Money

Suranjali Tandon

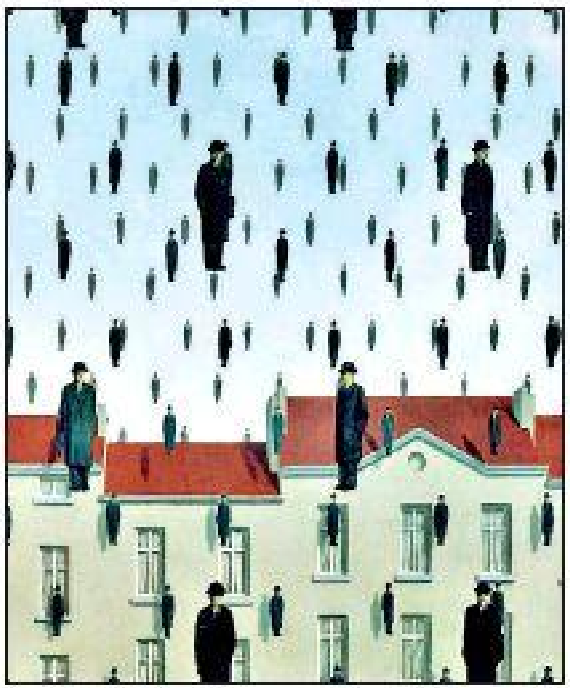
As climate change denial gives way to acceptance, economic activity agnostic to its negative externalities requires a rethink. Businesses must strategically rethink business models with a nudge from investors. But can centuries of corporate thinking be upturned to make room for social and environmental targets? After all, profit is the raison d'être for a business.

There are also concerns that while on paper, companies and investors commit to sustainability, often returns assume primacy and the 'Do good for all' motto is subverted. For the private sector to take heed of the warnings, the scientific results must be translated into the language of finance. That is, the impact of climate change needs to be demonstrated as potential risks and returns.

Risks are an effective means to signal costs of inaction. Like any other public policy issue, a cohesive framework must be designed by the government. Looking beyond the sector-driven narrative, or the need for predefined list of activities qualifying as 'green', it is important the macroeconomic risks of climate change are relayed. Central banks are in the business of maintaining price and financial stability and are at the heart of the transition. Through forward-looking policy, they can relay the present value of future climate change.

Temperature increase and CO_2 concentration tend to lower crop yields. Studies estimate that yields of wheat, rice, maize and soybean decline by 6%, 3.2%, 7.4% and 3.1% respectively with a 1° C rise in temperature. So, it's rational to expect food shortage, to the extent demand is inelastic and incomes do not uniformly decline. Thus, inflation targeting without sound assessment of climate risks is an incomplete policy yielding suboptimal economic growth.

In April 2020, the RBI acknowledged the potential macroeconomic risks from climate change. The study (bit.ly/3yTC7Pa) estimated that weather conditions, especially rainfall, have a strong influence on the trajectory of food inflation that lasted couple of months. The results also showed weather conditions have a significant impact on some key indicators of economic activity like Purchasing Managers' Index (PMI), Index of Industrial Production (IIP), demand for electricity, trade, tourist arrivals, and tractor and automobile sales.



Cost benefits in the air

Other studies show the persistence of inflationary pressures in developing countries up to eight years. Therefore, monetary policy can no longer adopt forecasting models blind to long-term climate risks.

Climate change also results in financial fragility. On the one hand, the transition away from fossil fuels can expose companies and bank balance sheets to potential valuation loss. On the other, sovereign downgrades based on climate risk assessment as well as physical risk exposure can lead to a contagion. Each of these are sizeable risks for the economy.

As of March 2020, 38% of the gross credit to industry was deployed in mining, including coal, fossil fuels, transport vehicles, cement, iron and steel, power and petrochemicals — all prone to transition risks. Moreover, the March 2021 study, 'Rising Temperatures, Falling Ratings: The Effect of Climate Change on Sovereign Creditworthiness' (bit.ly/3le6rPw), estimates that India's sovereign downgrade at the turn of the century, on account of climate risk, will be among the worst at 1.47 notches, which, in turn, will push up the cost of borrowing.

In fact, as per one estimate, sovereign bond yields peak at least 10 quarters after a shock in emerging markets and Asean countries. This would set in motion the process of contraction, and further curtail GoI's ability to borrow to finance the transition.

The active participation by central banks is often seen as unnecessary politicisation. However, such concerns are unfounded for India. First, climate change will impact the economy through inflation and financial instability. So, falling within the ambit of the RBI's goals.

Further, the RBI has a relatively broad mandate to maintain price stability. It is also expected to maintain confidence in the banking system while performing a developmental role by a range of promotional functions to support national objectives. Thus, incorporating green finance within the folds of the bank's mandate won't be a challenge. The RBI joining the Network for Greening the Financial System (NGFS) this year signals a positive step forward.

As the clock ticks on climate change, it is ideal to begin by understanding what it means for India. The financial sector responds best to the RBI's actions and a proper assessment, accompanied by disclosures of climate risk, can pave the way for action.

The author is assistant professor, National Institute of Public Finance and Policy (NIPFP)