Greening monetary policy

Lack of appropriate and adequate tools is an insufficient argument

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CLIMATE CHANGE BRINGS risks and uncertainty. How well monetary policy can incorporate these risks and uncertainties is a question many economists ask. There is a broad consensus among economists that fiscal policy can deal with the climate crisis, not monetary policy (due to lack of toolkits). It is widely acknowledged that public finance commitments and carbon emissions are inversely related. The public finance interventions through taxation to reduce carbon prints or public expenditure for supporting green energy and technology have proven effective in reducing emissions. However, such empirical evidence is absent in case of monetary policy.

India was the first to integrate climate change in inter-governmental fiscal transfers. The macroeconomic policy channel of this "ecological fiscal transfers" works through the public expenditure priorities on climate change commitments by subnational governments, to make a "just transition" towards a sustainable climate-resilient economy. The Fourteenth Finance Commission was the first to integrate climate change as a criteria for determination of intergovernmental fiscal transfers to the 29 states. The Fifteenth FC has retained the criterion. Within the environmental federalism framework, the "principle of subsidiarity" demands that the responsibility for providing a particular service should be assigned to the level of government closest to the people. This tax transfer is also to compensate for the cost disabilities of the subnational governments on account of revenue foregone and other opportunity-costs, such as protected areas, they incur in their path towards economic growth. However, ecological fiscal transfer is only one among many fiscal policy tools to ensure the climate change commitments.

In addition to these fiscal transfers, long term Public Financial Management (PFM) tools like climate-responsive budgeting at national and subnational levels are crucial to address climate change commitments. This PFM tool links national climate action plans to budgetary commitments. The roadmap and the analytical matrices to prepare climate-responsive budgeting can also eliminate the fragmented approach of line ministries towards adaptation and mitigation in India. However, differential tax rates can lead to "race to the bottom" to attract mobile capital and create 'pollution havens' through trade of lower environmental quality for more mobile capital.

On the monetary policy front, the climate-focused stress test conducted by the central banks is an upcoming policy tool to address the issue. Such green stress test is to assess how the banking system is exposed to climate risks and uncertainties. Such test was first conducted by the Bank of England. Christine Lagarde of the European Central Bank (ECB) is very supportive of greening monetary policy, and the ECB will conduct such tests of risk exposure of top banks in European Commission in 2022. However, Fed Reserve of US has not yet begun such tests. Fed chair Jerome Powell explained that the Fed has asked the lenders to articulate their risk exposure and how they can mitigate such risks. RBI has published a chapter on greening monetary policy; however, there is no further communication of toolkits. The response to the question whether RBI is open to conduct such green stress tests on the top banks is awaited.

Recently, professor Lars Peter Hansen, an economist at the University of Chicago, who was the winner of 2013 Nobel prize for economics, mentioned that there can be "reputation risks" if central banks go beyond their mandates. Former RBI Governor Raghuram Rajan said that central banks should turn their focus to the financial stability of the green investments instead of mandating purchase of only green bonds, not brown bonds, which is primarily a "fiscal" decision. The broad consensus is that central banks should focus on price stability and financial stability. However, this can be refuted by the concern that climate change is a crucial determinant of financial stability, and it is significant to integrate such climate-related risks and uncertainties in financing investment decisions.

In general, economists are apprehensive about the efficacy of central banks in dichotomising green bonds and brown bonds in their asset portfolio and moving towards a low carbon-emission enterprise. Policy prioritisation and political will are the prime determinants of climate change commitments. Lack of adequate toolkits is an insufficient argument.

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