AT A GLANCE

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MONETARY POLICY

Climate change considerations in monetary policy implementation

This overview was prepared ahead of the Monetary Dialogue between the Committee on Economic and Monetary Affairs (ECON) and the European Central Bank (ECB) President on Monday, 27 November.

Monetary policy is increasingly interlinked with the ambition of the transition to a carbon neutral economy. International developments, including the energy crisis after Russian war in Ukraine and potential spillovers from tensions in the Middle East, have highlighted the need to accelerate the green transition.

The relationship between climate risk and inflation has important implications on the effectiveness of the single monetary policy. ECB President Lagarde has argued that the ECB can play a major role in the transition by ensuring price stability. This would facilitate the reorientation of retained earnings towards green investments that would provide returns only in the late future. The ECB's economy wide climate stress tests have shown the importance of the transition to green energy to reduce risks over the medium-term.

Concern is emerging among euro area firms on climate change consequences in the next five years and questions remain on the effectiveness of monetary policy in this transition, particularly on the limited role that monetary policy could play due to the "*untargeted nature of conventional monetary and design restrictions of unconventional tools*".

ECB recent action to green its monetary policy

The **ECB has scaled up its effort to integrate climate change considerations** at the heart of its monetary policy:

- **In January 2021, a climate change centre was established** to coordinate activities within the ECB.
- **In July 2021, the Governing Council decided, as part of the monetary policy strategy review, to incorporate climate change considerations in the ECB's policy framework and committed to a roadmap of actions:** e.g., green considerations in the collateral framework, macroeconomic models and assessment of policy transmission; disclosures as requirement for collateral eligibility and asset purchases.
- **In July 2022, the ECB agreed on a further climate agenda** to integrate climate change considerations in its framework, e.g. tilting EU corporate bond holdings towards issuers with better climate performance as of October 2022; further embed climate change considerations in its collateral framework.

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The decision to unwind the ECB's balance sheet by means of discontinuing reinvestments under the corporate sector purchase programme (CSPP) is expected to slow down the ECB's ambitions to decarbonise the Eurosystem's bond portfolio. President Lagarde has reiterated that the ECB will assess options to ensure alignment with the Paris Agreement and further committed to continuing assessing ways to address climate-related concerns in monetary policy from 2024 onwards.

Overview of external expertise

Dirk Schoenmaker (Bruegel) argues that the ECB faces a number of trade-offs in its policy response to climate change and inflation. He offers **four key policy recommendations** to **1) maintain price stability** with a view of fostering a stable investment climate for green investments, **2) expand the low-carbon allocation in QE** to more assets, **3) expand the low-carbon allocation of collateral** by providing carbon factors to bank bonds and asset-backed securities, **4) recur to green TLTROs** to soften the impact of interest rate hikes on green investment. He finally recommends measures to preserve financial stability from climate-related shocks.

Daniel Gros (Bocconi University) and Farzaneh Shamsfakhr (CEPS) **highlight the marginal contribution that monetary policy can have on emissions**, particularly by means of greening the ECB's CSPP portfolio. They warn of the risk of backfiring of policies aimed at reducing the supply of capital to brown industries as capital-intensive high-emitting sectors would benefit from investments in mitigation efforts. They point to the **cap under the EU's emission trade system (ETS) creates a waterbed effect** which could create more room for the expansion of brown industry as the ECB seeks to favour green sectors. The authors also touch on the question of ECB's independence, warning of the lack of justification for the ECB to prioritise climate-related ambitions over other EU goals.

Sonja Dobkowitz, Pia Hüttl, Alexander Kriwoluzky and Jana Wittich (DIW Berlin) concur that reinvestments tilted towards climate-friendly issuers will only have a marginal effect relative to the large stock of existing overall bonds, yet deem necessary a rebalancing of the ECB's corporate portfolio via the active sale of positions. They also **call on the ECB to give preferential treatment in its collateral framework** to corporates with superior climate-performance and **provide better interest rates to climate-friendly investments** where this does not clash with the price stability mandate via refinancing operations.

Joscha Beckmann, Klaus-Jürgen Gern, Nils Jannensen and Nils Sonnenberg (Kiel Institute for the World Economy) argue that the **ECB can contribute the most to the transition by focusing on price stability**, which allows to stimulate investments and anchoring inflation expectations. While warning that the impact of other measures is probably limited, they also call for caution at the ECB. In their view, the ECB would have to consider the unwarranted side effects and conflicts within its mandate deriving from playing an active a role in the transition.

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