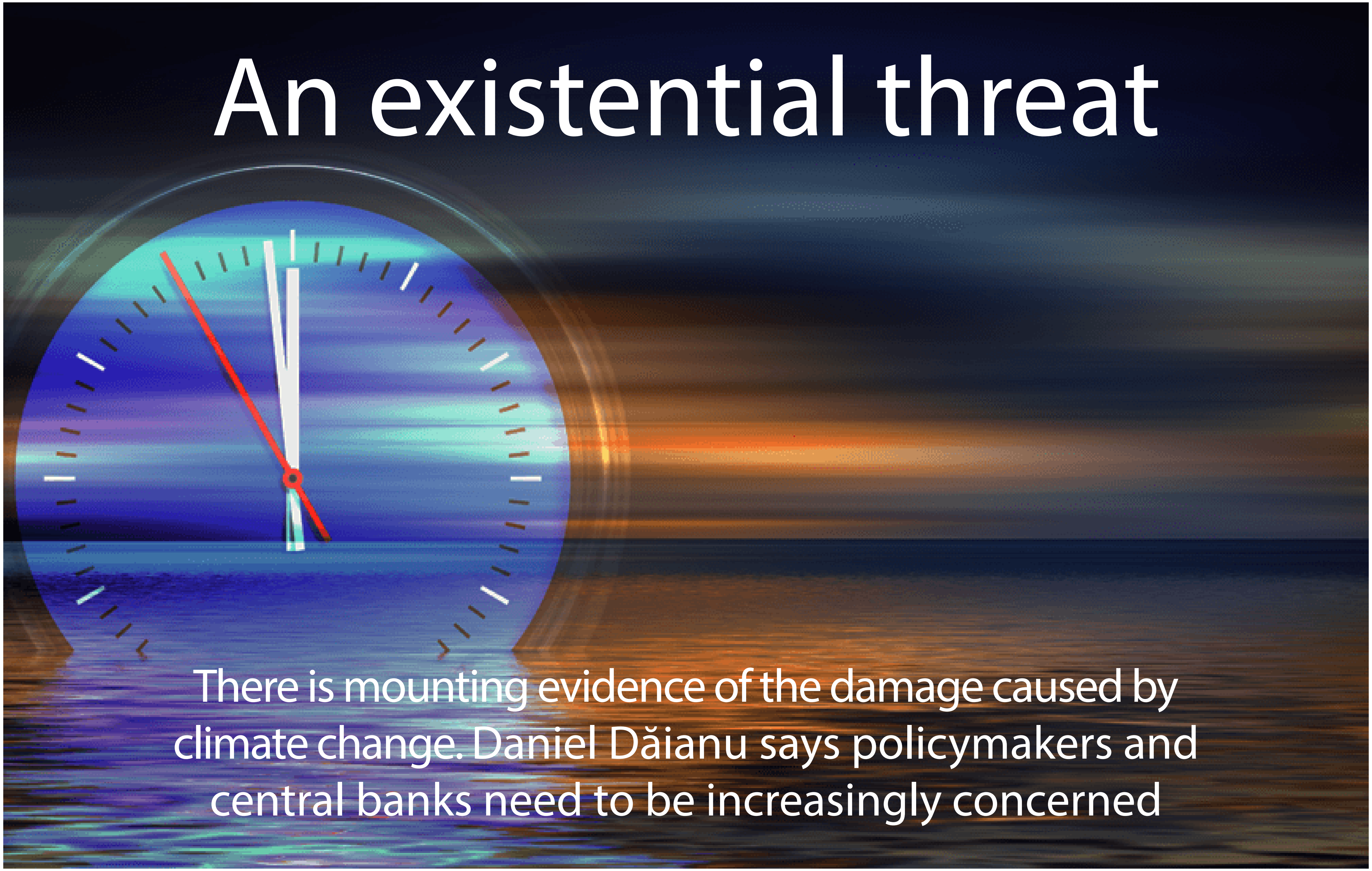

An existential threat

There is mounting evidence of the damage caused by climate change. Daniel Dăianu says policymakers and central banks need to be increasingly concerned

Financial markets are inherently myopic and misconduct is not rare. This means that proper regulations have to operate to rein in finance. Moreover, the Great Recession was enhanced by monumental failures of policymaking and a misleading paradigm, as Alan Greenspan ruefully remarked during Congress hearings in August 2008.

Let us recall the Big Bang of 1986 in the City of London, the rescinding of Glass Steagall in the US in 1998 and what followed via other waves of deregulation – with the emphasis put on 'self-regulation' (light touch regulation) according to the logic that markets know best, that they can regulate themselves!

But finance is not the most blatant case of neglect, or inadequate philosophy in policymaking. In 2006, in a famous report, Nicholas Stern, permanent secretary at the UK Treasury at the time, stressed that climate change poses the biggest challenge to economics, that markets can hardly account for climate change and their effects, that public policies need to address this reality sooner than later[1].

Nicholas Stern's views and those of scientists that think analogously (The Club of Rome, as a gathering of kindred spirits, being a most prominent one, the UN Intergovernmental Panel on Climate Change and various other groups of experts have also to be mentioned) have, arguably, been vindicated and there is a wide-spread wakeup call in this respect.

There is mounting evidence that points at an existential threat due to effects of global warming and overall climate change, to environmental degradation.

A recent article published by *Nature*, the distinguished scientific weekly, talks about a tipping point mankind may have already crossed and the existential menace unless resolute measures are adopted[2].

Climate change will, inter alia, foster more migration, massive shifts of population from inhospitable areas. And one can already see how disruptive such migration can be socially, economically, and politically.

A personal recollection deserves to be made by the author of this text (nota bene: who was an MEP). In 2008 and 2009, climate change was heatedly debated in the European Parliament, and action was asked for by many MEPs. Unfortunately, action was stalled, or derailed in advancing legislation and prodding other EU institutions to move forward resolutely.

Policymakers, in general, have to be much more attentive to sustainable growth challenges in their decision making

This occurred owing to the power of vested interests, of car manufacturers especially, and it should also be said, owing to various EU member states which flexed their bargaining clout. Ironically, some of those car manufacturers have been involved in big scandals for obnoxious practices in recent years; they cheated on emissions they produce. One has to add here disasters caused by the negligence of major oil and gas companies.

It makes sense to say a few words on central banks and their rising concern about climate change. For to see major central banks paying attention to climate change may surprise only a few. As a matter of fact, they have started to consider income distribution, new technologies (AI, digitalization, fintech/blockchain), cyber-warfare increasingly in recent years. Central bankers seem no longer to be like high priests.

Central banks realize that their conventional and non-conventional operations do have distributional effects, that income distribution does matter for a fair society, for the stability of democracy. And that, apart from the unknowns that they confront when overhauling their cognitive and operational frameworks, including how to integrate financial markets in their inflation targeting models (which used to assume that price stability implies, ipso facto, financial stability), there is a huge challenge posed by climate change. This is because climate change entails a different existential territory in view of the threats is poses.

A framework for understanding the concerns of central banks when it comes to climate change must consider, among other things:

- a dramatically changed environment (*"Low rates for longer with rising vulnerabilities…"* as the latest *Global Financial Stability* report of the IMF remarks), demographics, economic stagnation (or secular stagnation, as Larry Summers suggested by resuscitating an expression used by Alvin Hansen in 1937), and a *"regime change"* for monetary policy, as Olivier Blanchard put it[3];

- the exposure banks and other financial institutions have to sectors that are and will be severely impacted by climate change;

- de-carbonization of the economy , which is a must if mankind wishes to survive. Green finance is a catchword in this regard and central banks can and are supposed to do a lot in this respect by, among other things, accepting green bonds as collateral, or purchasing them outrightly.

By the way, there is a network of central banks that examine climate change seriously and aim at adapting their policies in this regard. This network was initiated by the Bank of England and includes the Bank of Canada, Banque de France, the Bundesbank. The ECB has joined this demarche and other central banks are likely to follow.

Reexamining monetary policy neutrality

But what about market neutrality? Should it be maintained as a central tenet of central banks' conduct when it comes to climate change?[4] This is a most critical issue to address. Central banks' stance may seem appropriate in view of their traditional philosophy not to interfere in markets' resource allocation function.

But, as it is alluded above, one has reasons to debate this stance in view of financial markets' inherent myopia and, when it comes to climate change, of massive inter-generational involved distribution effects, as well as negative externalities that are not factored in by markets.

As central banks have resorted to unconventional measures (QEs in particular), and in doing it, have considered, for instance, how to support SMEs, why not favour sectors that are lesser polluters and green industries? This is the spirit of green finance.

It may be that central banks have to broaden their mandate; as they pay attention to distributional effects of their operations, they have to consider climate change and whether they can do something about it as well. Not necessarily alone, certainly, but together with other public policymakers.

But, arguably, they may have to go beyond considering various risks and banks' exposure to sectors which are heavily impacted by climate change; they would need to think in terms of enhancing a sustainable habitat for people. This may imply a change of philosophy and conduct, of their 'institutional heart and soul'.

To sum up, three perspectives one can imagine on monetary policy neutrality: one that keeps things unchanged; one that keeps a neutral policy rate, but redefines neutrality; and one that discards neutrality. Let us focus on the latter two.

Redefining neutrality

A neutral policy rate (NPR) implies non-interference with market resource allocation. But NPR relies on potential output growth and takes the inflation target as the key parameter; some central banks consider also unemployment as a policy parameter (keep in mind the Unemployment Act of 1946 in the US). And potential output can be redefined in terms of 'welfare' (the ongoing debate on redefining GDP, shifting to Gross Welfare Product).

One can add another dimension to potential output/growth, namely 'sustainability', the extent to which economic activity harms the environment. Therefore, in a certain context, slower economic growth may be better than higher growth, a sort of steady state economics – as the leading ecologist Hermann Daly propounded decades ago. This happens when growth produces significant negative externalities.

The bottom line: the policy rate would consider a level of economic activity that takes into account social and ecological concerns. But who would define that level of economic activity?

This a fundamental question, for it may cripple central banks' independence to the extent 'non-harming environment potential growth' would be set by someone else.

Or central banks would not consider environmental concerns in their decision algorithms and governments, instead, would favor less carbon-intensive sectors as part of an overall industrial/environmental policy. In this case, central banks would maintain a monetary policy neutrality stance that would be quite similar to option one.

Discarding neutrality

Discarding market neutrality relies on a fundamental assumption: that markets are too myopic to consider ecological concerns. In this respect, one would make a distinction between accepting 'green bonds' as collateral and redefining the policy rate as a 'green policy rate'.

Discarding market neutrality introduces a clear bias in formulating the policy rate. As Mark Carney said: there could be an environmental Minskyan type moment.

Among aspects to consider are in this context are:

- heavy exposure of banks, of finance in general, to high carbon emitting (carbon intensive) sectors; the aim is to reduce this exposure, via regulation and preference for green bonds

- central banks need to work together with governments

- transition costs to a new, ‘sustainable equilibrium’ may be high, but unavoidable
- there is a coordination problem involved.

A key problem persists: who would set the policy rate? Another cognitive and operational issue: can we have models that, as finance is being taken into account in revised new Keynesian frameworks, consider environmental concerns too? Quite likely, this is possible.

There are influential voices (central bank governors included) who say that monetary policy is already overburdened, that ecological concerns should not constrain monetary policy further – Jens Weidmann, the governor of Bundesbank, is one of them. This view clashes with other central bankers’ view, who are keen on having central banks involved in combating climate change (Mark Carney, Villeroy de Galhau for instance).

The European Commission has named climate change one of its leading priorities, as a matter of fact its top priority. And it has asked the European Investment Bank (EIB) to be a *“financial engine of the low-carbon transition”* – while the president of the EIB, Werner Hoyer, talks about the power of green public finance[5].

Another policy issue is whether one can devise macro-prudential policies measures that consider environmental concerns by reducing overexposure to high-carbon sectors. This should not be a problem.

Can a carbon tax deal with negative externalities (as a group of eminent economists, including Nobel Prize laureates argued in a Wall Street message of 17 Jan 2018)? Taxes clearly can help since they influence incentives. But, as is the case with a Tobin tax, taxes may not be sufficient to change business conduct dramatically.

The corporate world, major companies in particular, have to turn into stakeholders, alter their short-termism in pursuing their profit objective. Ethical considerations have to get into the picture as well. Maximizing profits has to be constrained by other goals, by the need to make our life sustainable, by an injection of ethical values in decision-making processes.

Business models have to change, as would individual and collective habits have to. But can we change our economic and social models, 'reinvent capitalism'? There is an ongoing debate on this topic, that was triggered by the financial crisis and the waking up to the reality of proliferating 'winners take all' games, the erosion of the middle class[6].

Economics, applied economics in particular, need to overhaul themselves too. A few tracks of action are to be highlighted here:

- changing GDP to other welfare measure; the report produced by a group of economists led by Joseph Stiglitz and Jean Paul Fitoussi[7] comes to mind, and more recent work by Diana Coyle and Mariana Mazzucato as well;

- focusing on citizens' life conditions; some suggest that the median-income per capita should be a key measure for policymakers; that would hook up well with the notion of inclusion[8];

- how to make stakeholders' concept embedded into firms' natural temptation to pursue higher profits and be responsive to share-holders' interests remains a big challenge.

A recent open statement of the Business Roundtable in the US, that groups 180 CEOs of the most powerful American companies, suggests that something may have happened in their collective mindset in view of the natural calamities of recent years. These calamities can no longer be seen as isolated events, as tail events; they have become rather common occurrences and this cannot be looked upon nonchalantly.

Things have become very worrisome and we need to provide answers to key questions:

- can we summon the political will to do something significant about it?
- do we have the knowledge and the resources to change business models and society's interaction patterns in order to make transition to a sustainable life?
- can we do it at a time of a new 'cold war' between the US and an economically and technologically growing China? When Realpolitik and Geopolitics, Geo-economics are back in action so prominently?
- can the EU play a global coordinating role in this respect in view of Europeans' attachment to 'green values'?

Can powerful vested interests be overcome? Can all this be achieved within the time span that it appears we have at our disposal in order to obtain our habitat livable? How can we cope with so many disruptions and ruptures simultaneously?

Central banks have a major role to play not only since they have been regarded, justifiably or not, as *"the only game in town"* (Mohamed El Erian). Christine Lagarde's words in the European Parliament, where she indicated empathy with the idea that 'market neutrality' needs to be reexamined in the conduct of central banks, of the ECB, were quite refreshing.

Policymakers, in general, have to be much more attentive to sustainable growth challenges in their decision making. ■

Daniel Dăianu is Professor of Economics at the National School of Political and Administrative Studies, Bucharest, President of the Romanian Fiscal Council, Fellow of the Romanian Academy, former MEP, and a Former Finance Minister of Romania

Endnotes

1. Nicholas Stern, "The Stern Review: The Economics of Climate Change", London, LSE, 2006

2. "Climate tipping points: too risky to bet against", Nature, 27 November 2019

3. Olivier Blanchard, in his presidential speech at the annual AEA meetings of Jan 2019: ("Public debt and low interest rates")

4. See also Benoit Coere, "Monetary policy and climate change", ECB, 8 November 2018

5. Werner Hoyer, ""The Power of Green Public Finance", Project Syndicate, 27 November, 2019

6. Among thoughtful works are Paul Collier's "The Future of Capitalism. Facing the New Anxieties", Allan Lane, 2018; Raghuram Rajan, "The Third Pillar: How markets and the State leave Community behind" Penguin, 2019"; Paul Mason: "Post-capitalism: A Guide to Our Future", London, Penguin Books, 2015.

7. Joseph Stiglitz, Amartya Sen, Jean Paul Fitoussi, "Report of the Commission of the Measurement of Economic Performance and Social Progress", Paris, 2010

8. Klaus Schwab, "Ending short-termism in keeping score", Project Syndicate, 17 October 2019

This article is based on the presentation made at an ISEE (Institute for the Study of Extreme Events) seminar on climate change, Bucharest, Academy of Economic Studies, 23 October 2019.