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Central banks at the heart of ecological reconstruction

Policy Brief

- The unconventional monetary policies of 2008 became conventional in 2020.
- To date, they do not yet integrate the social and ecological imperatives of the coming decade.
- A new central bank regime must be structured around an internal coordination process with the financial actors of ecological reconstruction, and an external coordination to align the provision of international liquidity with the imperatives of ecological reconstruction.

Introduction

Faced with the pandemic crisis and its economic and financial consequences in the short and medium term, central banks found themselves in the position of guardians of chaos. They thus acted quickly and massively to avoid the potentially dramatic consequences of a sudden shutdown of a large number of Western and Asian economies. Faced with the reversal of capital flows out of developing and emerging countries, many of which found themselves in a foreign exchange crisis and in urgent need of liquidity. The US Federal Reserve (Fed) had to respond to a sudden demand for dollars and treasury bills. To do so, it sat up currency swap lines with a small number of countries and a sales and repurchase agreement for treasury bills for countries considered to be of lower political priority. In addition, the same Fed deployed an unprecedented battery of quantitative easing tools to stabilize domestic financial markets. At the same time, the European Central Bank launched its unconventional monetary policy program linked to the pandemic, the Pandemic Emergency Purchase Program (PEPP). The unconventional monetary policies of the 2008 financial crisis thus became largely conventional in 2020.

The triple health, environmental and social crisis, marks the entry into a new period of ecological tipping points. It invites us to debate around the principles of intervention by monetary powers. In Germany, the question of the delimitation between economic and monetary policy involving the Bundesbank, the German Supreme Court in Karlsruhe, and the European Central Bank is a case in point. In the United States, it is the fear of an acceleration of social imbalances potentially reinforced by these expansive policies that has recently preoccupied the Fed. As the IMF recently pointed out, central banks should be concerned in their mandate with the explosion of inequalities[1]. In the European Union, it is rather the ecological crisis and the risks for financial stability that preempt the debates. These different questions

> **"The European Union and China could play a joint driving role in this ecological redefinition of international liquidity."**

[1] Hansen N. J. H., Lin A. and Mano R. (2020), "Should Inequality Factor into Central Banks' Decisions?", *IMF Working Paper* WP/20/196.

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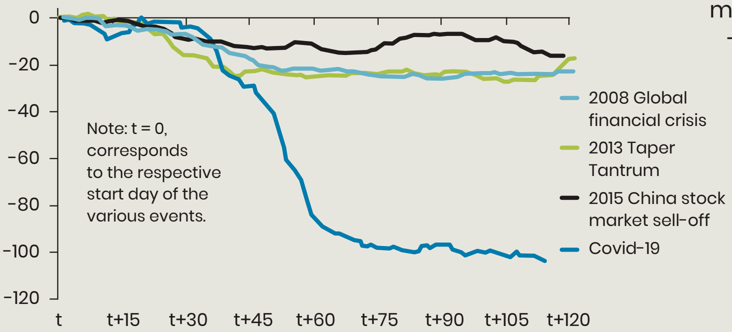
all ultimately touch on the issue of "market neutrality", which supported the principle of central bank independence in the last period. However, it is becoming increasingly clear that monetary policy, whatever it may be, always distorts the structure of markets[2]. And symmetrically, the financial markets themselves are fundamentally struggling to internalize the main social and environmental externalities that define the very possibility of societies' existence. Climate change is even considered by Lord Nicholas Stern as the greatest market failure of all time.

Some trends towards a new central bank regime are now discernible. Thus, several actions taken in the urgency of the pandemic crisis could be institutionalized, from the recent shift in objectives of the FED, which softens inflation control, to the reactivation of a short-term liquidity account between the Bank of England and the British Treasury; from the complete review of the European Central Bank's monetary operations through the prism of (notably) climate change to the Indonesian attempt to introduce a representative of the Indonesian Ministry of Finance to the Central Bank Council. These seemingly disparate and incoherent reforms all reflect a concern for the qualitative orientation of the practice of monetary instruments.

PORTFOLIO FLOWS TO EMERGING ECONOMIES TODAY VS. PAST EPISODES (BLN USD)



Source: Jonathan Fortun, Daily capital flows tracker. ©2020 Institute of International Finance, Inc. All rights reserved. http://www.oecd.org/coronavirus/policy-responses/covid-19-and-global-capital-flows-2dc69002/#figure-d1e212

Recommendations

But the emergence of a truly new regime for central bank action requires overall coherence. First of all, it is a matter of recognizing the necessary complementarity of monetary, fiscal and industrial policies in order to achieve the objectives set out in the Paris Agreement and in the future Kunming Agreement in one to two decades. This new coordination can materialize around two dimensions.

- The taxonomic definition of green and brown activities and its extension to an overhaul of accounting. Central banks that are actors of ecological reconstruction[3], must be involved in this redefinition of economic value. The European Union has developed a first taxonomy in this sense, giving objective criteria that can guide investors as well as central bankers. This exercise would benefit from including an evaluation of brownfield activities, and from extending it to take into account the decarbonation trajectories specific to developing or emerging countries.
- The joint mobilization of central banks on the one hand and public banks or national development banks on the other could be institutionalized through the shared and evolving use of this taxonomy. Development banks are indeed an available source of arrow financing, insofar as their social and environmental mandate is clear. The central banks of the NGFS network (Network for Greening the Financial System) could thus indirectly support development banks through asset purchases in foreign currency on secondary markets as part of their quantitative easing programs.

Beyond increased coordination among financial institutions and central banks at the national level, the need for multilateralism and international coordination in the management and direction of international liquidity has never been greater. This is evidenced by the recent debates on how to manage public debt at the international level following the COVID crisis, without sacrificing the macroeconomic conditions for ecological reconstruction, particularly in developing countries. In this respect, international liquidity and the conditions of access to it are decisive. Two types of proposals stem from this reinforced need for multilateralism.

- Forms of green swap lines could emerge between members of the NGFS network of central banks and emerging and developing countries, by exchanging currencies with countries engaging in recovery plans aligned with climate and biodiversity objectives. In particular, the European Union and China, being among the regional blocs most committed to respecting climate and biodiversity objectives could play a joint driving role in this ecological redefinition of international liquidity. Networks of multilateral development banks could provide a guarantee (under surveillance) that the projects financed will respect these ecological and social objectives.
- Countries with surplus unused IMF Special Drawing Rights (SDRs) could lend them to multilateral and bilateral development banks as part of plans to support the financing of COP21 (climate) and COP15 (biodiversity) targets still to come. Finally, the IMF could gradually transform the quota system into an SDR allocation system, based on the contribution to countries' ecological reconstruction efforts, taking into account the United Nations Framework Convention on Climate Change's principle of common but differentiated responsibility in the distribution of efforts.

[2] Schnabel I., "Never waste a crisis: COVID-19, climate change and monetary policy", Speech given at a virtual roundtable on "Sustainable Crisis Responses in Europe" organised by the INSPIRE research network, 17 July 2020.

[3] Bolton P., Despres M., da Silva L. A. P., Svartzman R. and Samama F. (2020), *The green swan: Central banking and financial stability in the age of climate change*, Bank for International Settlements, Basel.

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