

Green monetary policy – what instruments are most suitable?

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The position of the Association of German Banks on the ECB's green monetary policy

- Given the serious risks that climate change can pose to financial and price stability, the inclusion of climate protection aspects in the ECB's monetary policy is both pertinent and important.
- In certain situations, climate goals may conflict with price stability, which is why the ECB's strategy should consider green monetary policy only as a secondary objective.
- Non-permanent instruments, such as large-scale bond purchase programmes, are not particularly suitable for green monetary policy as there may be conflicts between the goals of price stability and climate protection when a restrictive monetary policy is in place.
- For better control of monetary policy, the ECB should focus specifically on any measures that would expand the collateral framework to include green bonds. One option would be to make the eligibility criteria more lenient for collateral based on environmental policy criteria.
- A general lowering of the haircut for green collateral could create an additional incentive for depositing this kind of collateral.
- For green monetary policy to be effective, an objective and standardised system for defining green bonds and securities is a must. It is important to continue to work on establishing a common classification framework within the EU (taxonomy), whilst not losing sight of the feasibility of implementing this framework in practice.

Sustainability is a part of the ECB's new strategy

The European Central Bank (ECB) published the findings of its strategy review at the beginning of July, much earlier than expected. As well as redefining its inflation target, the Governing Council of the ECB has decided to give greater consideration to climate protection aspects in future monetary policy. To achieve this, it has devised a comprehensive package of measures.

The reasoning behind this decision is that climate change can lead to extreme weather events or structural changes and thus threaten price stability in the euro area. However, in implementing its agreed climate-related action plan, the ECB will be limited by the clear boundaries of its mandate on ensuring price stability. Potential conflicts between its goals on climate policy and on price stability should be avoided.

Potentially conflicting goals

The mandate and therefore the primary objective of the ECB is ensuring price stability throughout the euro area. Given that climate risks endanger pricing goals, there is no fundamental conflict between climate and pricing objectives. Nevertheless, it is conceivable that there will be situations in which climate policy measures may hinder the ECB's efforts to maintain price stability. For example, where multi-level carbon pricing is introduced over a longer period of time, then climate policy objectives – insofar as the ECB commits itself to these objectives – could conflict with the goal of price stability. In addition, monetary policy measures that are required to maintain price stability may conflict with climate policy goals, for example where green bonds need to be sold by the central bank.

The ECB must stick to its own mandate should any of these conflicting objectives arise. It may only consider green monetary policy within its mandate, i.e. as a secondary goal, subject to the proviso that price stability is maintained.

Instruments for green monetary policy

The base interest rate is the ECB's most important monetary policy instrument. However, the ECB has not considered it as an instrument for targeted green monetary policy in its climate-related action plan. The main reason for this is that there is no clear indication as to whether a lower or higher base rate would support climate goals.

The ECB has therefore focused on monetary policy instruments in its action plan that it hopes will offer effective control options. These include:

- green quantitative easing (QE),
- climate-related reporting requirements and
- taking account of climate risks in the collateral framework.

Increased purchase of green bonds

European monetary authorities are planning to base future asset purchases on climate criteria, among other things. The ECB would become a major buyer of green bonds through its purchase programmes, which would tend to ensure higher bond prices and a low interest rate in this market segment. This is especially true given that the market volume of green bonds - despite its dynamic development - is still relatively small at present.

However, it is important to remember here that large-volume purchase programmes (quantitative easing, QE) are not suitable as a long-term monetary policy instrument. There will also be monetary policy phases in which the ECB has to curb the central bank money supply or even reduce it in order to guarantee price stability. When the ECB is pursuing a restrictive monetary policy requiring it to sell assets, the result is a conflict between the goal of maintaining price stability and climate policy objectives, if the ECB has previously purchased an increased number of – or exclusively – green assets.

Prioritising the purchase of green bonds as an instrument of green monetary policy would only be efficient if the ECB's QE programme were implemented as a "one-way street", effectively ruling out the sale of purchased bonds. Doing so, however, would severely curtail the range of monetary policy options available to the ECB.

As such, purchasing more green bonds would not appear to be a particularly suitable instrument for green monetary policy.

Climate-related reporting obligations

Another proposal from the ECB is to introduce climate-related reporting requirements as an eligibility criterion for the collateral framework and the ECB's purchase programme. However, introducing this criterion would restrict the ECB's eligible collateral framework and its purchasing options as part of its QE programme, with the consequence that, ultimately, they would also be restricting the effectiveness of monetary policy incentives.

The more convincing argument would be to offer positive incentives through climate-related reporting obligations. With regard to central bank eligible collateral, this could be done, for example, by targeting green assets more in the collateral framework.

Green bonds in the (central bank) eligible collateral framework

In order to prevent a clash of objectives and avoid dampening the effects of monetary policy instruments, the ECB should concentrate on permanently expanding the eligible collateral framework to include green assets when it implements its climate-related action plan. If rating agencies were to factor in climate-related risks to their credit assessments, this would allow preferential treatment to be given to green collateral by making the eligibility criteria more lenient. Such considerations would be justified because there are fewer climate-related risks associated with green collateral, which ought to make the likelihood of default somewhat lower – all other things being equal.

The collateral framework and haircuts

Sufficient collateral has to be deposited for all lending operations in the Eurosystem. The Eurosystem creates a list of assets it considers to be eligible collateral.

A haircut is applied to the value of the collateral, which serves as a buffer to account for lost value and the time needed to sell the collateral. The amount of the haircut depends on the type of collateral, the time to maturity, its coupon and credit quality.

The inclusion of climate-related risks in company ratings would also have an effect on haircuts in the Eurosystem's collateral framework. Furthermore, a general lowering of haircuts for green collateral would also be justified since, as with the idea of making eligibility criteria more lenient for green collateral, the principle that green bonds mitigate overall climate-related and price risks could also be applied to haircuts.

By expanding the collateral framework to specifically include green collateral and climate-aligned haircuts, the ECB would benefit from an environmental policy instrument that was both easy to modulate and highly market and risk-based. In contrast, by concentrating on its purchase programme, the ECB could quickly reach the limits of its monetary policy mandate. Especially when its current expansionary policy on the supply of central bank money eventually needs to be curbed again.