°224

Central Bank Swerving from Its Path

The Executive Board of the European Central Bank (ECB) wants to make monetary policy "greener." Hardly a week goes by without the topic being promoted by one of the board members. In addition to the visible effort to make the traditionally dry seeming monetary policy appear practically helpful and close to the people, the ECB's activities in the matter itself amount to a further significant expansion of its competencies. This involves, first, independently assessing the environmental friendliness of projects financed by corporate bonds; and second, giving preference to positively rated projects in various securities transactions.

It is not easy for those who want to criticize this policy, as it is readily assumed that critics are not interested in climate issues or that they have a negative attitude toward European institutions. Neither applies to us: we are concerned about the legitimacy of the independence of a central bank that is stretching its mandate into the political realm.

The Three Building Blocks of "Green" Monetary Policy

The legitimacy of "green" monetary policy is based on a presumed contribution of green monetary policy to price stability, a generous interpretation of the ECB's mandate, and a postulated market failure. We want to look at these building blocks in detail.

In the first line of reasoning, the idea is that climate-related environmental disasters could cause certain prices, such as food prices, and thus inflation to rise. This would mean the ECB is called upon to prevent climate change. Such long-term effects are certainly conceivable, but they have not been investigated sufficiently to derive quantifiable recommendations for short-term, monetary policy measures. For one thing, the direction and magnitude of the impact of climate change on individual prices are difficult to predict. For another, it is unclear to what extent climate change can be controlled by European monetary policy, since it is a global phenomenon. Above all, however, there is no credible link between individual prices and the ECB's primary objective. Relative prices must fluctuate in a market economy. The risk of fluctuating food prices is just as compatible with the objective of price stability as the risk of fluctuating commodity prices. The ECB's objective is the stability of the overall price level and thus of purchasing power. It best protects monetary stability by responding directly to a rise in inflation or inflation expectations by tightening monetary policy.

The stronger argument is that climate-related disasters could complicate monetary policy management if they affect the financial sector, and therefore the central bank would have to take action against climate change. If this argument were viable, however, the ECB would have to assess and counter risks in many other policy areas as well. It would have to get involved in foreign or trade policy to prevent wars or trade conflicts and the resulting financial crises. And yet no one is calling for this, at least not so far. The line of reasoning chosen by the ECB about possible direct price and indirect financial market effects is not valid precisely because it would no longer allow monetary policy to be distinguished from other policy areas. The ECB would become an influential and at the same time independent actor in areas for which, for good reasons, elected parliaments and governments have so far been responsible. At the same time, calls for further corrective distributional policy interventions would be likely, since not all economies invest equally in green projects. This would be all the more likely if the ECB were to consistently extend a preference for green bonds to government bonds as well.

Support for Economic Policy?

An alternative argument holds that monetary policy should also support the EU's general economic policy in accordance with the Treaty, provided that this does not run counter to the objective of price stability. But can the ECB pursue climate policy via the bond market without compromising on the objective of price stability? The answer is not straightforward. If "green" and other bonds are considered close substitutes in the market, it does not matter which bonds the Central Bank buys for the transmission of monetary policy to the real economy. The prices of both bonds then go hand in hand anyway. But then green monetary policy would actually be ineffective. If, on the other hand, there is no perfect substitutability between the bonds, a central bank transaction will have different effects across economic sectors.

Central banks cut key interest rates to near zero percent in the wake of the financial crisis; since then, they have tried to stimulate aggregate demand and inflation with direct purchases of securities. Investors are to be persuaded to reallocate their portfolios so that risk premia fall. Still, the chain of effects is uncertain and makes inflation more difficult to manage. Focusing purchases now on green bonds in accordance with a climate target, rather than broadly across all eligible segments of the bond market, leaves the effectiveness of monetary policy even more vulnerable to sector-specific variations. However, greater variance in inflation would clearly contradict the price stability objective.

Moreover, green bond purchases create a trade-off: Selective measures can achieve something only if enough bonds are purchased, but this is not always called fore in terms of monetary policy. Alternatively, there may be too few of the eligible green bonds available. Therefore, the ECB's room for maneuver is in fact quite limited: seriously pursuing a goal other than price stability practically always gives rise to a conflict of objectives.

The third argument – that the market is failing to price climate risks in corporate bonds – is weak because it is not clear why the ECB, of all actors, would be able to identify this. Measuring market failures often cited in this context, such as shortened time horizons in pricing, is difficult; otherwise, there would be a lot of money to be made. Even if it were possible, there are better alternatives to such discretionary intervention by central banks in the bond market. The simplest are a global CO_2 price or the global issuance of emissions licenses. Monetary policy cannot substitute for this. To the extent that adequate CO_2 prices exist, additional monetary policy interventions are counterproductive because they prevent an efficient allocation of CO_2 savings among sectors.

The fact that the ECB has so far held only a small volume of green bonds due to its selection criteria does not yet justify an ad hoc adjustment of these criteria. Rather, in view of the applicable law, these must be selected in such a way that price stability can be achieved in the best possible way.

European Central Bank Would Overstep Its Mandate

The ECB has steadily gained influence since its foundation. This applies to its participation in the Troika in the context of the European debt crisis, the extensive takeover of banking supervision, or the country-specific purchase of government bonds, which is at the intersection of monetary and fiscal policy even when interpreted benevolently. Unlike these past steps, we believe that the ECB is clearly overstepping its bounds with a "green" monetary policy. It enters the space left to it by political institutions too readily. Parliaments and governments may seem overwhelmed, but it is not the central bank's job to assess whether or not they are. The ECB's foray into an environment-based valuation and preferential treatment of bonds is damaging, and not only in terms of monetary policy. Even if it were not formally illegal, it would turn monetary policy into an environmental policy actor without a legitimate democratic mandate that the European Treaties certainly did not intend to install.

Modesty and self-restraint in monetary policy set incentives to solve problems where they arise. They should be the virtues of every central banker. A monetary policy that strives for popularity and does not take the limits of its mandate seriously undermines its independence in the long run.

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