New climate in monetary policy

FRESH AIR. Climate change can cause financial churn and roll interest rates via changed savings behaviour. New tools are on the anvil.

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Notwithstanding the criticality of climate-related concerns in recent times, such concerns, by and large, remained outside the domain of core macroeconomic issues. In other words, global warming and climate change issues tended to elude key macroeconomic concerns, like growth, inflation, interest rates, or exchange rates.

In this context, RBI's Report on Currency and Finance, 2022-23 assumes importance. With a subtitle, "Towards a Cleaner Greener India", the report flags climate-related concerns and brings these to core macroeconomic issues.

To appreciate the criticality of climate change for the economy, consider some indicators: episodes of climate change in India flagged by the report.

First, India faced its hottest February in 2022 since record-keeping began in 1901.

Second, in 2022, India experienced extreme weather events on 314 of 365 days of 2022, which claimed little more than 3,000 lives, affected 1.66 million hectares of crop area, and killed nearly 70,000 animals.

Third, in 2022, India recorded its seventh wettest January since 1901 and March 2022 was the third driest and warmest ever in 121 years.

Finally, it has been estimated that without any policy action, India's CO2 emission level may rise from 2.7 billion metric tonnes (in 2021) to 3.9 billion metric tonnes by 2030.

These numbers are grim and should convince anyone that climate change is no longer in the periphery but like the proverbial elephant in the room has entered our home, and we can neglect it at our own peril.

But how can central banks handle the concerns of climate change? Aren't they ill-equipped to handle these problems? The report is profound in pointing out, "...even if governments are the most influential agency for climate change, all institutions, including central banks and financial sector regulators/supervisors, are stakeholders and especially so in view of the existential threat to their central mandates". Illustratively, the report flags the critical role of climate change in generating demand and supply shocks over business cycles.

The following are worth mentioning in particular. First, price stability can be affected by climate change via supply shocks like food and energy prices. Second, climate-related risks can affect inflation volatility which could potentially de-anchor inflationary expectations. Third, natural disasters could lead to loss of income and health, leading to adverse demand shocks. Fourth, physical and transition risks can affect the balance sheets of financial institutions and banks, which could have an adverse impact on the flow of credit. Fifth, climate-induced uncertainty could lead to a rise in precautionary savings with an attendant impact on interest rates. Sixth, a change in risk perception arising from climate change could lead to episodes of financial instability.

What is the impact of climate change on the Indian economy? The report noted, "India's diverse topography makes it vulnerable to significant risks from climate change, evidence of which are increasingly visible in rapid changes in temperature, variations in SWM (South-West monsoon) rains, rising frequency and intensity of extreme weather events such as unseasonal rainfall, heatwaves, cyclones and floods. Besides, balancing environmental and economic goals could pose serious challenges in India's ambition to become an advanced country by 2047.

To gauge the state of our consciousness on climate change, the report mentions an anonymous informal survey of various financial institutions was conducted in December 2022. According to the respondents, the energy and mining sector was identified as the most exposed to climate risk, followed by automobile, agriculture, infrastructure, and construction sectors like textiles and engineering were not expected to have significant exposure.

ROLE OF FINANCIAL SECTOR

What is the role of the financial sector in handling climate change? Remember, insofar as the financial sector is related to the real sector, the financial sector is affected by climate change, but at the same time, it can throw up some solutions for mitigating climate-related risks. Climate change can amplify various types of risks in the financial sector, such as credit risk, market risk, liquidity risk, and operational risk and is likely to have adverse implications for financial stability.

Since environmental pollution is primarily seen as an externality, the solution packages traditionally encompassed correcting such distortions via traditional measures like carbon taxation. Besides, technological innovation in clean energy and appropriate trade policies are thought through. Interestingly, increasing emphasis is being placed on the financial sector to devise the solution package. For example, several countries have taken recourse to Sovereign Green Bonds, which are traditional government securities except that "they contain a "use of proceeds" clause which states that the funds will be utilised solely for green investments. The report delves into using monetary policy tools for countering the menace of climate change and goes on to mention ingenious policy tools like green quantitative easing (such as, a targeted scheme to provide low-cost funds to banks for lending to firms engaged in the renewable energy space), relaxing collateral policy for access of liquidity, CRR exemptions on green credit, even introduction of central bank digital currency from green considerations.

The report highlighted some of the key initiatives of RBI in this area, illustratively, the RBI released its discussion paper on climate risk and sustainable finance in July 2022. The discussion paper provided broad guidance for RBI-regulated entities to develop good practices on some issues, such as (a) appropriate governance; (b) climate risk strategy; and (c) risk management structure. Later in January 2023, the RBI issued sovereign green bonds to mobilise resources for the government for green infrastructural investments. More recently, in April 2023, the RBI released the framework for mobilising green deposits.

The RBI report brings some fresh air into this arena and mainstreams such concerns about climate change.

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