Political Uncertainty in Central Bank Responses to Climate Change

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Central banks have increasingly been paying attention to climate change. The Network for Greening the Financial System (NGFS), the international organization founded by a small group of central banks dedicated to pushing forward central bank responses to climate and environmental issues, now counts 138 members. The Basel Committee for Banking Supervision has since the beginning of 2020 had its own climate-focused task force. Central banks have now begun to respond to the imminent challenge of climate change across their functions, from bank supervision to monetary policy operations to stress testing. Underpinning this has been a growing literature providing the scientific and technical basis for central bank climate action, as researchers (sometimes in-house, sometimes externally) have made the case for the impacts of climate change on central bank objectives, and begun to explore the salience of policy responses such as green refinancing facilities and green-preferenced collateral.

However, central banks have not responded uniformly to the challenge posed by climate change, both in their timing and scope of action. The People’s Bank of China and Chinese banking regulator have been steadily addressing environmental issues from at least the mid-2000s, via a number of regulatory programs designed to address relevant credit risks as well as the integration of environment and climate-related targets into several monetary policy programs designed to steer credit into priority activities. In Europe, the Bank of England (BoE) and other early movers like De Nederlandsche Bank, Banque de France, and then the European Central Bank (ECB) scaled up their climate responses progressively over the second half of the 2010s, initially focusing more narrowly on the material risks posed to banks by climate impacts and a green transition, before later introducing climate-related conditions on asset purchase programs, albeit with limitations. In the US, the Federal Reserve (Fed) held off on any climate-related response until only recently, and has focused more narrowly on a risk-based, largely prudential approach. Scholars in this space have

come up with several ways to classify the varied policies that central banks have pursued in response to climate change. Most share in common some distinction between policies that aim to mitigate the risks that flow to central bank objectives as a result of climate change, and those that actively seek to respond to climate change by targeting the financing conditions for different sectors or activities.

There are still many open questions about how central banks should respond to climate change, both in the technical sense (which policies with which parameters will be most effective?) and in the normative sense (which types of policies are within central banks' institutional scope, and which goals should these policies pursue?). On this latter question, central banks' new attention to climate change has served to reinforce the ways that they are ultimately public, and political, institutions. Research has demonstrated the ways that central banks are responsive to political developments related to climate change. This is true in terms of direct political pressure put on central bankers by elected representatives, for example via letters, committee hearings, strategic policy documents, and sometimes mandates, all of which have been key elements in adding climate change to central bank agendas. This dynamic is also observed in the ways that central banks are responsive to the broader social and political contexts within which they are situated, where public opinion, research agendas, non-governmental organizations and beyond constitute an environment that makes central banks more or less likely to add climate issues to their agendas. The primary reason that political developments are important to central banks is their public status: while the particulars may vary across countries, central banks are ultimately dependent on their legislative and executive bodies for their ongoing autonomy. Crucially, this is true even in the context of strongly held norms around central bank independence, where the central bank is given a large degree of operational latitude.

However, while it is clear that linkages are present between central banks and their political environments, it is not always clear how these linkages actually operate or are influential. Furthermore, central bankers themselves face a similar lack of clarity in navigating how these political relationships *should* operate. The rest of this short piece will be devoted to exploring two varieties of political uncertainty that are integral for central bank responses to climate change. The first concerns the boundaries of central bank mandates as they relate to climate change. In the absence of other forms of democratic direction, central bank mandates become a key instrument in legitimizing central bank climate policies. However, central bank mandates in reality are vague and involve substantial interpretation, and provide little direction for how central banks should

respond to new policy areas and making them a deficient instrument for this task. The second pertains to the absence of a stable political consensus around a low-carbon transition, particularly relevant in certain jurisdictions. How can we remain committed to democratically legitimate central banking in the context of a divided 'demos'? I put forth that rather than use this instability as an excuse for inaction, we must remain committed to democratically aligned central banking.

Type I Uncertainty: Central bank mandates and scope for action

As independent agencies with a high level of discretion, central bank mandates are essential tools for guiding the direction and scope of central bank policy. Mandates come directly from the democratic bodies to which central banks are accountable. Many central banks do not receive intermediate directions from these democratic bodies. Thus, mandates are often the primary device that central bankers use to legitimize their tools and policy decisions. Several excellent works of legal scholarship have reflected extensively on central bank mandates and independence. In this context, I'd like to offer a few further reflections on the uncertainty central banks continue to face as these mandates relate to climate change.

Central bank mandates generally share commonalities, usually including an objective for price stability or similar. Some mandates also include additional objectives to support government general economic priorities. For example, a central bank like the ECB is mandated to "support the general economic policies in the Union." One must note however that the ECB should pursue this supportive mission "without prejudice to the objective of price stability". In distinction, other central banks have a mandate only more narrowly focused on price stability, though usually with reference to broader macroeconomic goals. For example, the Bank of Japan's (BoJ) monetary policy should be "aimed at achieving price stability, thereby contributing to the sound development of the national economy."

What these mandate differences mean in practice, however, is far from resolved. In the US, central bankers and the financial media have pointed to the Fed's lack of secondary mandate as compared to their European counterparts as a relevant consideration in setting the scope for Fed intervention, for example when it comes to implementing green-supporting or brown-penalizing factors into bank capital requirements. Fed officials have

often raised their mandate as a key consideration in setting the scope for their climate response, calling it "important, but narrow." Central bankers in other jurisdictions have also sought out legitimation via their mandates. For example, in the UK, where the BoE does have a secondary mandate, BoE Governor Andrew Bailey explicitly sought a climate addition to the BoE's annual remit letters for the Bank to pursue climate-related policies with more explicitly allocative dimensions. The logic would seem to flow that if central banks have a mandate to support government priorities, and those priorities include climate change, this provides a basis for central banks to not only address climate change but to pursue policies that more actively seek to support a low carbon transition.

This logic is not wrong, but it is perhaps incomplete. When looking across a broad spectrum of central banks, there is little resolution as to whether a central bank in fact needs a secondary mandate in practice to more actively support a low carbon transition in line with government priorities, for example through policies like preferential lending programs. For example, while the BoJ is not explicitly mandated to support economic policy priorities in the same way the ECB is, the BoJ in 2021 set up a program to provide zero-interest loans for financing climate-friendly projects. This is in line with a more recent history at the BoJ of similar lending operations.

There are two points to be made in this context. First, these inconsistencies in the application of central bank mandates stem from the fact that these mandates only offer very high-level objectives, requiring a high level of discretion in interpreting and applying them. Central bank mandates are often unclear as to which intermediate goals (for example, relating to climate change) and policy tools are within central banks' scope, with their application reflecting a set of norms rather than clear instruction. Even for central banks like the ECB that do have a secondary mandate, its utilization (or often lack thereof) over time has primarily been shaped by circumstance and central banker discretion, rather than driven by clear democratically-informed processes.

Second, this mandate uncertainty stems from a broader democratic deficit in central banking. That democratic deficit is reflected in the need for central banks to rely heavily on mandates alone in the absence of other regular forms of coordination with or direction from their governments. While there is relatively stable consensus that central banks should have a level of discretion in setting policy rates, for example, the activities of central

banking and thus the boundaries of central bank independence beyond rate setting are hardly straightforward.

Type II Uncertainty: (In)stability in the political consensus for action

A second major, and underexplored, source of uncertainty for central banks is how to act in the face of political instability in responses to climate change. Government commitments to low-carbon transition pathways are important in providing a level of democratically-endorsed certainty for central banks considering how to support an "orderly transition" (which could include both risk-mitigating and credit-shaping policies). In the UK and the EU, these have included legally binding policy commitments to a 2050 net zero target. However, these commitments are not always stable. For example, in the US the Trump administration withdrew from the Paris Agreement in 2017, followed by the Biden administration rejoining it in 2021. With the 2024 presidential election there is yet another possibility for a withdrawal, or at least another broad reversal on domestic climate-related policies. This hardly provides a clear transition pathway. In Japan, political will on climate action has only recently grown in the past several years, and even in the UK cracks have more recently formed in the consensus on climate action under Prime Minister Rishi Sunak's leadership.

Recent years have witnessed a burgeoning literature on how democratic delegation can function better in central banking. This has especially been the result of a context of substantial expansion of central bank roles and policy instruments in the years following the Great Financial Crisis (GFC) of 2007-8. Particularly in the West, central banks have expanded their operations from a narrow focus on interest rates as the primary policy tool for managing inflation, to a much broader set of objectives around financial stability and non-financial sources of systemic risk and a broader set of tools including large scale asset purchases and more active credit guidance. This expansion has seen central banks placed more centrally in debates around the distributive impacts of central bank policy, and thus reignited this interest in more democratic central banking. This had resulted in two connected areas in the literature: first, arguments that central banks have become more politically entangled in the years since the GFC, and second, arguments that as a result, central banks should have more direction from their political authorities (as in the prior section of this essay). But a missing link in this literature is how we can reconcile more democratic central banking with a glaring lack of consensus around shared political goals.

Put otherwise, how can central banks follow the 'demos' when divisive issues such as climate change are at stake? From a practical perspective, providing central banks with principles to deal with this uncertainty is a worthy, if challenging, task.

Scholars who advocate a 'broad social consensus' view[i] on central banking argue that delegation to central banks is only legitimate on issues where a broad social consensus for certain policy priorities or a certain policy course exists, and those priorities and policies are best handled by the central bank. This view certainly holds weight in principle, but poses challenges in implementation, where nailing down precisely what a broad social consensus means is difficult. Taking the US as a case study, it is not unusual for the democratic process to operate with razor thin margins. Vice President Kamala Harris is now the record holder for most tie-breaking votes in the Senate of any vice president. The Fed's proposed new Basel III rules have been hotly contested, both among members of Congress, and more broadly as banks have mounted a fierce campaign against the new capital regime. There is no clear consensus on these new rules among experts nor among society. And yet filling the "gap between expert consensus and ultimate policy decisions" must nonetheless proceed through this divided democratic process; waiting for a clear consensus to emerge is not a practicable option. As Peter Conti-Brown writes in his essay linked in the prior sentence, there is no consensus that exists beyond majority.

So where does this leave the central banks on climate change? The biggest risk of this type of political uncertainty for central banks is that it will lead to a lack of action. If the preferences of elected governments are likely to flip-flop with each electoral cycle, wouldn't it be easier to do nothing at all, or at least keep policy at a conservative baseline even when there is majority support for further-reaching policy? The problem with central banks choosing this course of action is that they are not making a politically neutral decision, but one that cedes power both to the policy preferences of those who would prefer inaction, and the private financial sector in determining how to manage climate risk and how the transition will unfold. We must not mistake social and political dissensus instead as a consensus for inaction. Of course, the answer is also not that central banks should choose democratic misalignment in the opposite direction by consistently making far-reaching distributive decisions in the absence of alignment with existing policy priorities. While inconvenient, central banks must not shy from a democratically informed approach to their tasks, even if that means that priorities may shift over political cycles.

Conclusion

This short essay has sought to outline two of the most challenging sources of political uncertainty central banks face in determining the nature and scope of their responses to climate change moving forward. First, central bank mandates are key tools for legitimacy, but leave central bankers with substantial uncertainty around which types of climate-related policies are within their scope. This more broadly is a symptom of a lack of clear and consistent democratic direction for central banks from their political authorities. Second, central banks face uncertainty around how they should act in the face of an unstable political consensus on responses to climate change and decarbonization pathways. On this, I have argued that it is vital we do not mistake a lack of consensus for action instead as a consensus for inaction, and that we remain committed to democratic principles even where instability is present.

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[i] Paul Tucker is perhaps best known for this view in his book Unelected Power, however credit for coining this term to describe this literature is due to Leah Downey in her 2021 article.