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Climate change as a source of challenges for the Eurosystem's monetary policy

Climate change is a legitimate and serious source of concern for central banks in their role of defining and conducting monetary policy.

Indeed, climate change will affect monetary policy in two ways. On the one hand, most economic variables that are critical for the diagnosis underpinning monetary policy objectives and decisions, such as production, productivity and prices, will be affected by climate change, because of more frequent and more intense extreme weather events and gradual warming and because of the adverse outcomes caused by the transition to a low carbon economy. On the other hand, the transmission mechanism of monetary policy itself is vulnerable to climate change because of the latter's potential negative reverberation on the functioning of financial markets and the strength of financial institutions' balance sheets.

Against this backdrop, central banks face a threefold challenge. First, climate shocks can be non-linear, making the evolution of climate-related risks difficult to predict and a significant source of uncertainty, which will make it more challenging than today for central banks to evaluate their own policy space. Then, the question for them is the following: how to assess thoroughly the implications of such uncertainty for the design of their monetary policy? With respect to inflation targeting, this may include parameters that are critical for central banks' credibility, such as the nature of the policy target, its level, or the horizon over which this target should be met. Second, central banks need to beef up rapidly their analytical capabilities to be able to factor in climate-related shocks in their models and assessments. Third, central banks should look thoroughly at the implications of climate change for their monetary policy operational framework. That includes the eligibility, mobilization rules and the valuation of the collateral they accept in their credit operations to the extent that these assets carry climate-related financial risks, which are not properly factored in by financial markets. From a broader perspective, central banks also need to determine if and how they could play a catalytic role and foster collateral and financing practices in the financial system that are aligned with meeting the Paris Agreement 1.5°C objective. Acting as a catalyst does not necessarily mean changing the mandate of the central bank. Rather, it would imply to factor in, when this is feasible and relevant, climate-related considerations in the design of monetary policy operations.

The Eurosystem, confronted with such climate-related challenges, intends to address them candidly. Accordingly, the monetary policy implications of climate change are one of the main workstreams of its on-going strategy review, which is due to conclude in the course of 2021. ●