MP briefing: Monetary policy, climate change and nature-loss

November 2024

This briefing explains the implications of climate change and nature loss for monetary policy, the Bank of England's progress on green monetary policy, recent changes to the Bank of England's remit, and suggested questions to ask the Treasury.

Climate change, nature loss and central banking

Climate change and nature degradation are relevant to central banks' primary objectives of price and financial stability, as they pose risks to both:

- **Financial stability:** the physical impacts of climate change and nature degradation (such as the impacts of extreme weather on buildings), as well as the transition to a net zero and nature-positive economy (such as investors and consumers moving away from fossil fuels), could impact the value of financial assets. If this is disorderly, this could lead to a sudden market crash (BoE, 2024).
- **Price stability:** climate change and nature degradation, have inflationary impacts that may hinder central banks' ability to achieve inflation targets.

Many central banks (including the Bank of England) have secondary objectives to support Government economic policy, which often includes mitigating climate change and/or supporting the net zero transition.

The Chancellor updated the remits for the Monetary Policy Committee (MPC), Financial Policy Committee (FPC) alongside the 2024 Mansion House Speech. Both remit updates emphasised the Government's objective to *accelerate the transition to a climate resilient, nature positive and net zero economy',* and the role of the financial sector in '*supporting the transition to a net zero economy'* (See annex for further detail).

Climate change and nature loss have economic impacts that are relevant for monetary policy

Acute and chronic impacts of climate change and nature loss are relevant to monetary policymakers, because they impact the economy.

Climate change and nature loss will reduce global economic output:

- The Network for Greening the Financial System's November 2024 models foresee a 15% loss to global GDP by 2050 under current policies. This is a significant increase from the previous 5% estimate in the 2023 models (NGFS, 2024).
- The Green Finance Institute estimates that nature loss could result in a 12% loss to UK GDP by the 2030s (GFI, 2024).
- These are likely to be underestimates, due to inherent uncertainties around when, how and where climate impacts will occur, and limitations to models, which do not consider climate tipping-point dynamics, socioeconomic impacts (like migration and conflict), and compounding risks.

Climate change, nature loss and fossil fuels are all drivers of inflation:

- Fossil fuel prices driving inflation is a longstanding phenomenon, most recently triggered by Russia's invasion of Ukraine, with energy prices contributing up to 75% of UK inflation between 2019-2023 (Positive Money, 2023).
- Climate change impacts inflation via many channels, but a key driver is reduction in agricultural activity and damage to crop yields. European Central Bank researchers have forecast that climate change could lead to an increase in food price inflation alone of up to 3.23 percentage points per year by 2035 (Kotz et al., 2024).

The case for green monetary policy

When inflation is driven by energy price shocks and climate impacts, rising interest rates can hinder, rather than help, to bring down inflation:

- Interest rates cannot address the drivers of these sources of inflation, and disproportionately increase the cost of investment in projects that will reduce the risk of future shocks and make the economy more resilient to them.
- For example, renewable energy projects require large amounts of up-front investment, and so are particularly sensitive to rising interest rates. Evidence suggests higher rates have led to project delays and cancellations (e.g. Vattenfall delayed its UK offshore wind project in 2023).

Many tools for managing inflation driven by energy prices and climate change lie outside of the powers of central banks, and there is a case for rethinking how we respond more effectively to future inflation, as has been recently proposed by the Deputy Governor of the Bank of France (Bénassy-Quéré, 2024).

However, central banks can adapt the policy tools they do have, to ensure that they do not run counter to the transition to a net-zero and nature-positive economy.

The Bank of England's progress on greening monetary policy has stalled

In the September 2024 update to the Green Central Banking Scorecard, the Bank of England fell to 7th place amongst G20 central banks' for green policies:

- Whilst the BoE still received a 'C' grade, it has been outpaced by other countries and dropped from its previous position of 5th in 2022, and 4th in 2021.
- The ECB, and Germany, France, Italy, Brazil, Japan, China and Indonesia have all committed to, or implemented, more and/or higher impact green monetary policy initiatives than the Bank of England (see rankings).

The Bank demonstrated early leadership by greening its corporate asset purchases, however this is no longer an active policy tool:

- In 2021, the Bank applied green criteria to the corporate assets it purchased under Quantitative Easing, on the rationale of 'support[ing] an orderly economy-wide transition to net zero' (BoE, 2021).
- As the Bank has now sold most of these assets, this policy is no longer active.

The Bank has made some progress on greening its day-to-day lending tools for commercial banks, but more is needed:

- Central banks provide liquidity to commercial banks on a daily basis by lending them reserves in exchange for financial assets as collateral.
- Rules for which assets are accepted, and on what terms, are known as the 'collateral framework'. Assets accepted, and with more favourable terms, receive a premium from commercial banks, with issuing companies enjoying cheaper borrowing costs due to the central bank signalling that the asset is 'safe'.
- The BoE has made some changes to collateral eligibility and haircuts for residential mortgages, based on energy efficiency and physical climate risks (BoE, 2024).
- However, the Bank has not yet adjusted collateral eligibility and haircuts for corporate and bank assets in relation to climate change and nature loss, missing an opportunity to send a clear signal to the private sector.
- The Bank should apply exclusions to assets from issuers whose main economic activity is misaligned with climate and nature objectives, and adjust the terms at which it accepts other assets according to environmental impacts.

The Bank has yet to address the impact of high interest rates on green investment by introducing a 'dual interest rate' scheme to pass lower interest rates to green projects:

- The Bank's Term Funding Scheme was set up to offer cheap funding to commercial banks, provided that they demonstrate they have expanded lending to households and businesses. The most recent iteration offered additional incentives for SMEs.
- With the Bank now easing monetary policy, the scheme could be adapted and re-opened to ensure that the Bank's rate cuts are passed through to green sectors, or to offer below Bank Rate funding for lending that would particularly support price stability, such as retrofits and renewable energy, as has been proposed by MPC member Megan Greene and Oxford Sustainable Finance Group.

Suggested questions for HM Treasury

- *What is their assessment of the need to rethink the current approach to managing inflation driven by supply-side shocks?*
- *What implications do the new edition of climate scenario models from the Network for Greening the Financial System have for the Government's policies?*
- *What assessment has been made of the impacts of the Bank of England's fall from 5th to 7th place in the 2024 Green Central Banking Scorecard, for the Government's goal for the UK to be the leading green finance centre?*
- *What estimate has been made as to how much additional financing could be delivered by repurposing the Bank of England's Term Funding Scheme to pass through lower interest rates to clean energy companies?*

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Annexe: Recent changes to Bank of England remit letters

The primary objectives of the MPC and FPC are to support price and financial stability:

- Subject to primary objectives, the MPC and FPC have secondary objectives to support Government economic policy, which the Chancellor is required to set out at least once every 12 months in annual remit letters.
- For the FPC, the Chancellor also specifies: matters relevant to the financial stability objective; the responsibility of the FPC for achieving that objective; and the responsibility of the FPC in relation to supporting the Government's economic policy.
- Acting on climate change and nature loss is relevant to the Bank's primary objectives, given the risks posed to price and financial stability, as the Bank itself has stated (see Talbot, 2024; Mann, 2023; Breeden, 2023).

In recent years, climate and net zero have been in both committees' secondary objectives. Changes in emphasis has shown to impact upon the Bank's strategy and resourcing of this work:

FPC remit letter and climate change:

- Since 2020, climate change has been listed as relevant to the financial stability objective, and net zero listed within the list of the Government's main economic policies to which the FPC should support (see 2020, 2021, 2022, 2023 remit letters).
- In FPC remits, the Chancellor also outlines specific policy objectives for the financial services sector. From 2020-22, this included *'align[ing] private sector financial flows with environmentally sustainable and resilient growth*'. In 2023, this was removed, and in a February 2024 evidence session with the House of Lords Economic Affairs Committee, Andrew Bailey stated that the Bank had reduced its climate work in response to this change, as appears confirmed in the Bank's 2024 Climate-Related Financial Disclosure (BoE, 2024). This was criticised by experts, given the relevance of climate to the primary objectives (Positive Money, 2024).
- **The FPC's remit was updated in November, emphasising both climate and nature risks and the role of the financial sector in supporting the net zero transition.** The remit lists climate change and nature risks as relevant to the FPC's financial stability objective, lists *'Leading the world in sustainable finance*' as a priority for the financial sector, and both the *'transition to a climate resilient, nature positive and net zero economy'* and the financial sector's role in, *'supporting the transition to a net zero economy'* as part of the Government's main economic strategy (FPC Remit 2024).

MPC remit letters and climate change:

- Since 2021, the transition to a net zero economy has been listed as Government economic policy to which the MPC should support, with minor changes in wording (see 2021, 2022, 2023 MPC remit letters).
- **The MPC's remit was updated in November, emphasising both climate and nature risks and the role of the financial sector in supporting the net zero transition.** Alike with the FPC remit, Government economic objectives listed include to '*accelerate the transition to a climate resilient, nature positive and net zero economy*', and the role of the financial sector in *'supporting the transition to a net zero economy.'* (MPC remit 2024).