The Covid-19 crisis and the subsequent economic downturn have reinforced the need to evaluate and address highly disruptive environmental-related events.

Banks have not been the problem but part of the solution in the Covid-19 crisis. This is because after the global financial crisis of 2008-09, banks’ capital and liquidity was reinforced and they were subject to stress tests. Back then, the US Federal Reserve had to inject massive amounts of dollars into the system, with swap lines from other central banks.

In March 2020, the Federal Reserve had to intervene again to avoid a market meltdown. The question is whether we are entering a period of instability where the lender of last resort has to be permanently on call to avoid a systemic crisis.

The Covid-19 crisis and the subsequent economic downturn have reinforced the need to evaluate and
address highly disruptive environment-related events. It has reinforced the financial stability mandate of central banks, which was forgotten in the so-called ‘Great Moderation’ period from the mid-1980s until 2007, with its exclusive focus on inflation targeting.

**Stability remit**

It must be pointed out that the original purpose of central banks was to maintain financial stability. Looking forward to potential disruptions ahead because of climate change, the policy response to stabilise the financial system should avoid an excessive reliance on central bank help to limit moral hazard, and this needs appropriate prudential policy and investment in mitigation.

A more controversial question to ask is how climate change risk considerations should impinge on the conduct of monetary policy. For example, by applying the neutrality principle, central banks are tilted towards assets from companies associated with high carbon emissions, whether directly or indirectly. It is always worth remembering that central bank policy has to be consistent with government mandates.

**A combined effort**

The fight against climate change will require a combination of public intervention with private sector mitigation strategies to price and hedge the long-term implications of climate-related events. Carbon pricing is an ideal solution that has proved difficult to implement. This is why governments and companies around the world make carbon abatement proposals, including net-zero commitments, to decarbonise the economy.

This opens the door to the role of asset managers and financial markets to facilitate the management of climate risk and stimulate mitigation efforts by the private sector. A major difficulty is that the systemic nature of natural disasters complicates hedging by market players because of the lack of effective risk-sharing. There is evidence, however, that investors and markets are starting to price climate risk.
Furthermore, universal owners, such as large pension funds, are increasingly aware of the danger posed by systemic risk induced by climate change. So far, shareholder activism has proved helpful in forcing disclosure of climate-related information but mandatory disclosure policies may be necessary if greater disclosure is desired.

The Covid-19 crisis has made evident that the balance sheet of the public sector is needed to control and alleviate the effects of systemic risks. Apart from the help to households and firms in trouble, the public-private partnership that has made possible the fast development of vaccines — such as Operation Warp Speed in the US — provides a good example. Could this be the model to fight climate change by investing in new mitigation and decarbonisation technologies?

A basic problem is that firms will not invest enough in decarbonisation because they do not take into account the positive external effect that their investment has. Due to these externalities, a tax on capital to fund mitigation might be needed to restore efficiency in carbon emissions. We may envision sustainable finance mandates, backed by financial intermediaries, that are a substitute for such a tax, but they should be significantly more stringent than what we have now.

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