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Europe in motion for climate transition: snapshot, video and scenario of the risks

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Ladies and Gentlemen,

It is a pleasure to be with you today, despite the war in Ukraine that is clouding our minds. In this era of urgency, we have to cope with multiple crises at the same time. And the latest IPCC report, despite being widely overshadowed, reminds us of another burning priority, and how much this Sustainability Week is welcome. It would be tempting these days to prioritise emergency over sustainability. But as the famous detective fiction writer Raymond Chandler wrote in the Big Sleep: "There is no trap so deadly as the trap you set for yourself". To avoid the lethal trap of short termism, let me propose today two simple remedies: (I) Europe must remain in pole position to achieve net zero emissions, and (II) we need to elaborate further on the macroeconomics of climate and how it is interfering with the current energy crisis.

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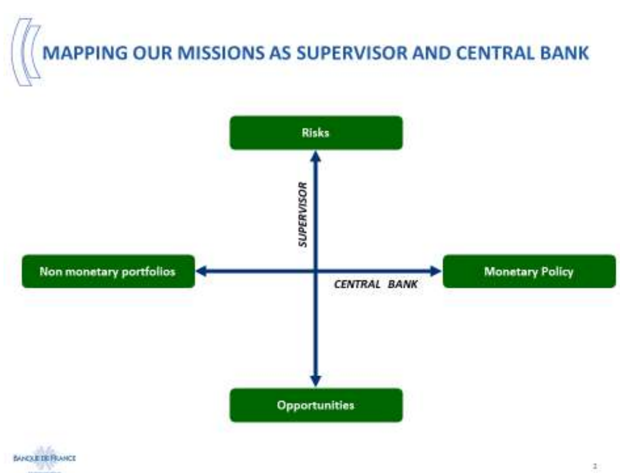
<u>I. Europe must remain in pole position to achieve net zero emissions</u>

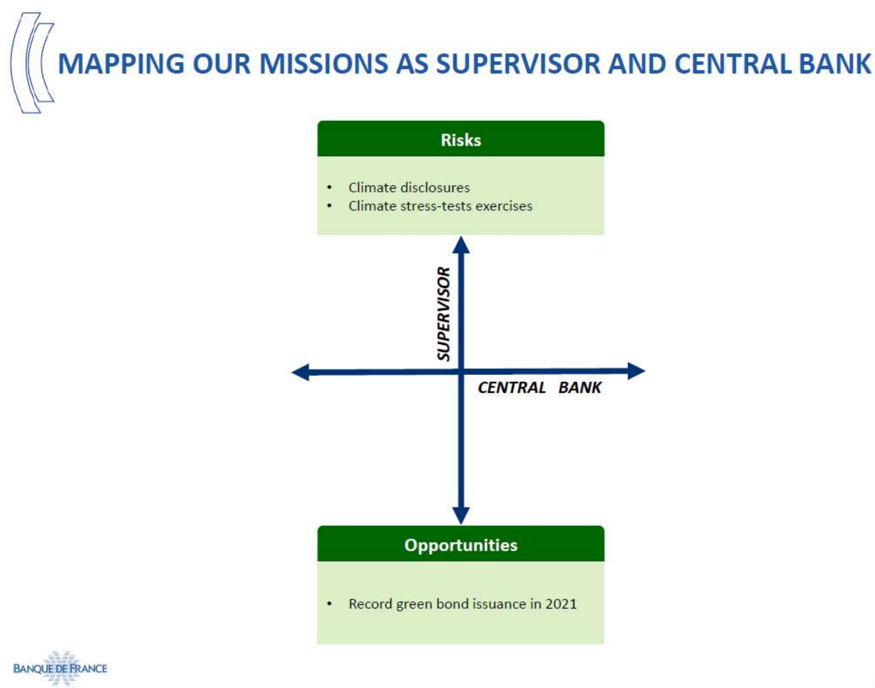
The European Union has committed to ambitious carbon-cutting targets, with the aim of reducing its 1990 emissions levels by 55% by 2030, and of reaching net zero by 2050. The Eurosystem is largely contributing to this momentum, with the view to implementing its actions in line with progress on EU policy and initiatives – and I must stress here that the Banque de France has often been a driving force. Our actions are two-pronged, as shown by the axis in this quadrant.



We first need to foster financial **opportunity**, as the corresponding financing needs are massive: at least EUR 350 billion in annual additional investment is required to meet our objective by 2030[i]. There is no choice but to accelerate the rapid development of green finance. The green bond market is indeed growing at a record-breaking pace: it doubled in 2021, reaching EUR 460 billion worldwide – half of which is denominated in euro.

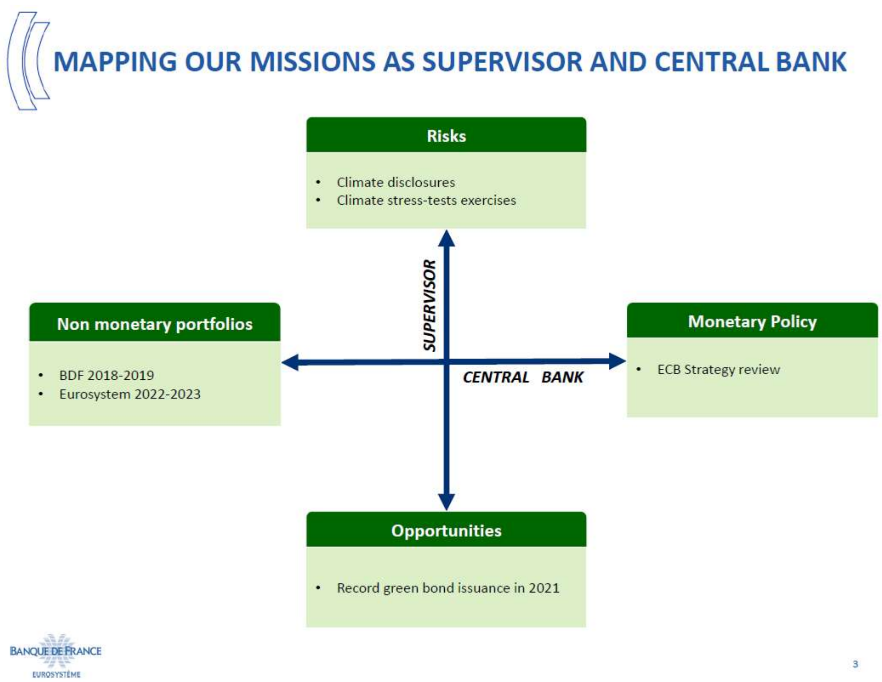
This strong momentum in green financial markets is good news, on the critical condition that their promises are kept. It reminds us of the Platonic myth of the Ring of Gyges:[ii] by granting a shepherd the power to become invisible, it removed his fear of committing unjust acts. Greenwashing should not be the assassin of green finance. Europe is hence actively working to **increase transparency and mandatory disclosure** for a sounder market discipline and a better capital allocation. All large companies will be required to publicly report the alignment of their activities with the taxonomy – on this issue, achieving good compromises is more efficient and intelligent than seeking perfectionism forever – and to disclose data based on forthcoming ESG standards – which would apply from 2024 through the Corporate Sustainability Reporting Directive (CSRD). Disclosure also applies for financial products deemed "sustainable", [iii] and will be complemented by an official label for green bonds, the *European Green Bond Standard* – which will hopefully be adopted by the summer. International cooperation on the development of extra-financial standards, especially between the EFRAG (European Financial Reporting Advisory Group) and the ISSB (International Sustainability Standards Board), will be key to ensuring their comparability and interoperability, while avoiding harmonisation towards the lowest common denominator.

On the vertical axis, as **supervisors**, increased transparency provides a clearer picture of **climate-related risks**. The disclosure/snapshot of present risks was further improved through the conduct of forward-looking climate stress tests – the "video" of long-term risks: the French supervisor, the ACPR, realised last year the first "bottom up" exercise, while the ECB initiated its own exercise in January this year. As a first stage, these stress tests should be made compulsory for banks and insurers. Let us fine-tune the methodology, and (only) once climate-related risks are properly evaluated, capital add-ons could, as a second stage, be required by supervisors. In addition, banks should be required to publish transitions plans to be assessed by supervisors: a misalignment with the climate policy target could be seen as an indication of material transition risk – leading potentially to a capital add-on. In any case, I would favour Pillar 2 capital add-ons, given the need to ensure availability and comparability of data on assets. And these add-ons should remain wholly **risk-based**, rather than conceptually colour-based: let us be cautious about simplistic and binary green supporting factors, or brown penalising ones.



Turning to our actions as a **central bank**, we first practice ourselves what we preach: there is nothing better than leading by example. The Banque de France was the first Eurosystem central bank to adopt a **responsible investment** Charter in 2018 for its own funds portfolios. These are already aligned with a 2°C strategy, and will be gradually lowered to 1.5°C. We will progressively extend this to our whole non-monetary portfolios. Eurosystem central banks are also committed to implementing a sustainable and responsible strategy for euro-denominated non-monetary portfolios, and to disclosing the first results by 2023.

On the **monetary policy side**, the ECB has formulated an ambitious action plan to be implemented by 2024, to which the Banque de France made a decisive contribution[iv]. Among other actions, it aims to impose transparency requirements on eligible assets and issuers – and this should also apply to asset-backed securities and covered bonds. It also includes the incorporation of climate change considerations into its monetary policy operations, notably through a tilting of the CSPP programme and differentiated haircuts for collateral, based on climate risk criteria. This should incorporate credible metrics including all indirect emissions that occur in a company's value chain (the so-called "scope 3" emissions). We should also adopt a forward-looking approach by taking into account corporates' commitment to reducing their emissions: when it comes to climate transition, the path is just as important as the starting point, and a dynamic approach is better than arbitrary exclusions.



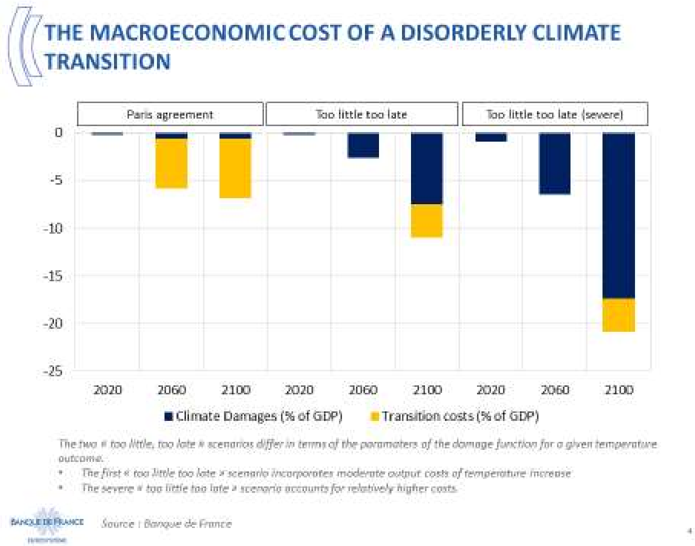
Let me add that beyond climate change, the loss of biodiversity is emerging as a topic of concern for the financial sector: on Thursday, the NGFS and the research network INSPIRE will publish the last report of a series on biodiversity loss and financial stability, building on collective efforts across central banks and academics, including from researchers at the Banque de France.[v]

II. The macroeconomics of climate and its links with the current energy crisis

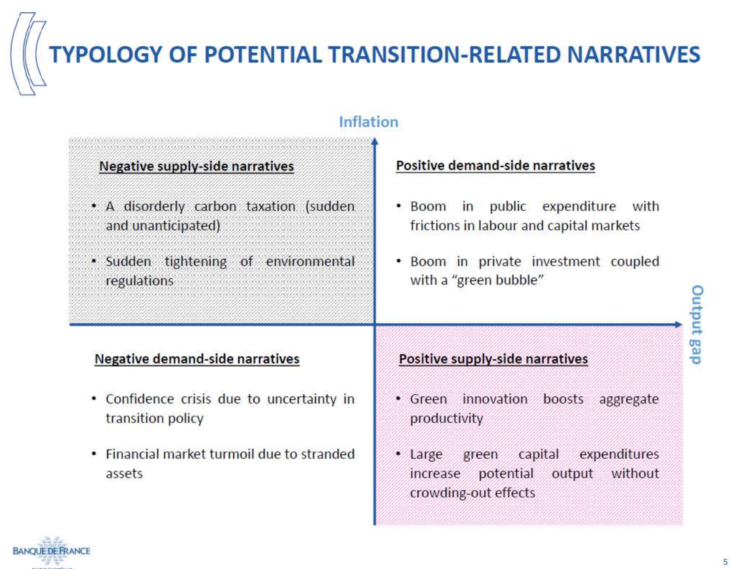
Upstream, thanks to the IPCC, we have made significant progress on the **physics** of climate change. Downstream, also on green finance as a facilitator for businesses' transition. But in between, there is a missing link: the macroeconomics of climate, and how it affects growth and price stability. This is why its incorporation into macroeconomic modelling is one of the ECB's priorities.

In such a highly uncertain environment, **scenario analysis** has proven useful to help plan policy responses. Through fruitful cooperation between 108 supervisors and central banks around the world, the NGFS (Network for Greening the Financial System) – whose global secretariat is based in Paris – has developed detailed macro-financial scenarios: they provide the most comprehensive framework to date for climated-related financial risk assessment. By this summer, the NGFS will update its six financial scenarios, closely aligned with their applicable corresponding IPCC climate scenarios. They will include a better assessment of physical risks and macroeconomic developments, with further clarity on price dynamics. This is a great success, but it's just the beginning. Next year, the NGFS should continue (i) to better model physical risks, and (ii) add sectoral and geographical granularity while finishing to fully incorporate the latest relevant IPCC results. It should also supplement these scenarios with a series of more adverse short-term and medium-term scenarios (2030) modelling an acceleration of climate change and transition.

Overall, the results of climate-related scenarios are clear-cut: the sooner we tackle the transition, the lower the cost in terms of GDP.



Under the “too-little, too-late scenarios”, the overall GDP loss could range between at least 10 and 20% of world GDP level at the end of the century, against 7% in the “Paris Agreement” scenario. However, these estimates do not capture more volatile developments that may arise in the shorter term, due to disorderly transition or unexpected policy changes. Will there be such thing as “greenflation”? We need a **typology of potential shocks** – demand and supply-driven – to correctly assess the implication of transition risks on price stability and growth.



Such shocks could have an inflationary impact, most notably in the event of a negative supply shock, especially a disorderly one, as we are currently seeing as a result of the war in Ukraine. Conversely, disinflationary developments could arise in the event of heightened uncertainty or financial turmoil, due to stranded assets for example.

Such effects are likely to combine, amplifying or mitigating the overall impact; what is most likely though is that some inflationary pressures may result from the transition, especially in energy prices.[vi] But let me clarify one point: climate transition policies are not the culprit for the present surge in inflation. According to our estimates, the increase in carbon prices related to the EU Emissions Trading System only explains 7% of the rise in electricity prices in 2021 in France.

Speaking about short-term unexpected developments, the climate transition is clearly at risk of being overshadowed – and possibly delayed – by the war in Ukraine. The quickest measures to reduce Europe’s dependency on Russian gas could result in some countries in an increased reliance on coal and oil. Moreover, Russia’s war is likely to translate into slower growth and higher-for-longer inflation, and hence less fiscal and monetary space to finance green technologies.

There is therefore an urgent need to find a “path of compatibility” that both promotes our energy autonomy and ensures our transition to a low-carbon economy. To do so, public and private stabilisers will prove to be useful resources to cushion the economic fallouts from the conflict, while providing the necessary resources to accelerate investments in sustainable activities. First, the **Next Generation EU** programme which already dedicates 30% of its budget to the fight against climate change, should be boosted. But beyond this, private investment will be key: the EU happens to have the world’s greatest pool of savings – EUR 300 billion in excess savings – at its disposal. It’s time to build the bridge between these financial resources and our energy investment needs, by finally achieving a genuine single financing market. Christine Lagarde rightly advocated last May a **Green Capital Markets Union**[vii].

On the **ECB**'s side, we should follow our path of gradual normalisation of monetary policy to keep inflation expectations anchored – it is indeed time to take our foot off the accelerator, as decided during our last Governing Council. That said, we should not overreact to short-term volatility in energy prices, and instead focus more on underlying inflation and on the medium term.

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I must stress the remarkable alignment of public and private interests regarding this green financial issue that have been seen over the past years – but this is just the beginning. And this cannot be the only lever as nothing will replace a carbon price; green finance cannot be the only green game in town. Rest assured that central banks will do everything they can to foster the transition in the very name of their mandate. Thank you for your attention.

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[i] European Commission, Communication from the Commission to the European Parliament, the Council, The European economic and social committee and the Committee of the regions, Strategy for Financing the Transition to a Sustainable Economy, 6 July 2021.
[ii] Plato, Republic.
[iii] Sustainable Finance Disclosure Regulation
[iv] Villeroy de Galhau F., "The role of central banks in the greening of the economy", speech, 11 February 2021.
[v] Svartzman, R. et al, "A "Silent Spring" for the Financial System? Exploring Biodiversity-Related Financial Risks in France", Working Paper Series no. 826, Banque de France, 27 August 2021.
[vi] Schnabel I., "A new age of energy inflation: climateflation, fossilflation and greenflation", 17 March 2022.
[vii] Lagarde C., "Towards a green capital markets union for Europe", speech, 6 May 2021.