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"The long run: the road to net zero and the role of central banks"

Speech by Olaf Sleijpen at the Green Economy Conference organised by the Bank of Lithuania
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I come from a country with a history of fighting against water. One quarter of the Netherlands lies below sea level. Another one third of the country is vulnerable to flooding from rivers and lakes.

Since we are so vulnerable to the impact of climate change, you might expect the Netherlands to be a front runner in the race for net zero.

But to be honest, we are not. We lag behind the European average by almost any measure. We are among the countries with the highest per capita carbon emission in the EU. Our percentage use of renewable energy is only one third of that in Lithuania.

These are painful facts. Yet, I think I have a story to tell that might be of interest to you. Because the threat of climate change to the economy and financial system is so great, as a central bank we got involved in the climate debate early on. As an insider to the debate, we learned how complex the energy transition is. And we learned one or two things that might help to get it going.

I know some are still skeptical about whether central banks have the mandate or the impact to get involved. On the mandate issue I can be very clear. According to the IMF, the Financial Stability Board, and others, climate change is a major threat to our economies, our financial systems, and our prosperity. The German government alone set aside 30 billion euro for reconstruction after the recent floods. According to climate scientists, this is only the beginning. So, with the stakes so high, central banks, as guardians of financial stability, cannot stay on the sidelines if they want to remain fit for purpose.

Central banks can have impact in various ways. Of course, they can take sustainability factors into account in their reserve management and monetary policy operations. Often, this is difficult enough, as I can tell from experience. But their influence reaches much further. Central banks are also providers of independent, high quality economic research. They can deliver the facts. They can point to the risks for the financial sector and the economy. And central banks naturally have a long run view. That makes them ideally placed to assess climate-related policy options, whose full impact may only become apparent in decades. They can show which policies are effective and which are not. Show what the tradeoffs are. So that politicians and other decision makers can agree on the economic facts, and make decisions based on these facts.

And those central banks that are also financial supervisors, such as the Bank of Lithuania and the Dutch central bank, can also take that risk management view. Zooming in from the macroeconomic level right down to the individual institution. By demanding from banks, insurance companies and others that they know their exposures to climate-related risks, and that they manage them properly.

Because financial institutions are vulnerable to a changing climate. First of all there are the physical risks, for example due to the financial fall-out of extreme weather events. Just ask the German insurance companies. They face 11 billion euros in claims after the floodings. And the risk is broader than climate change. Dutch financial institutions alone have over half a trillion euros in exposures to companies that depend on natural ecosystems. These are companies whose business may be at risk due to biodiversity loss and other forms of environmental degradation.

Financial institutions also face transition risks. Take for instance a bank that provides a loan to a car manufacturer. That loan may become non-performing if the manufacturer fails to build clean vehicles and keep up with changing energy regulations and consumer demands. So climate risk is a new and important driver of financial risk.

One area where central banks can make a difference, is in identifying barriers for sustainable finance. In many countries, including my own, current levels of sustainable investment and finance are still insufficient to meet the Paris objective. Worldwide private investment in fossil fuels and infrastructure is still three times higher than sustainable energy investment.

The question is why? And how can we scale up green investment?

At the Dutch central bank, we have tried to provide answers to exactly these questions. You can read them in our report ‘Financing the Transition’, which we published last summer. We prepared this report primarily from a Dutch perspective. But you may wrestle with similar issues, which is why I'd like to bring it up here.

We identified three main barriers to sustainable finance.

First of all, the business case for sustainable investments is still poor. Often, the risks do not outweigh the returns compared to carbon-intensive investments. Underpriced carbon emissions are a key factor. Currently, 20 percent of all carbon emissions worldwide are priced. So 80 percent are not. In the EU, the carbon price in the Emissions Trading System has strongly increased recently. But many sectors, such as transport, aviation and agriculture, are still exempt.

So we need the price of carbon emissions and other greenhouse gasses to go up. Effective carbon pricing is the one thing that will make all the other things that we do, much more effective. An EU carbon border tax that is compatible with international trade rules will probably be necessary to keep an international level playing field. And even if emissions are adequately priced, government support such as guarantees, cheap loans and subsidies will also be needed to stimulate green investments.

The other factor that undermines the business case for green investment, is the high financing risk involved. Green investment is often innovative, long-term, and it has an uncertain payback period. And the profitability of climate investment depends on future government policy, which is often uncertain. This makes investment less attractive to private parties, unless they are offered a high risk premium.

So better carbon pricing needs to be part of a consistent, long-term and credible transition plan. A plan that's still in place when the next government takes over. A plan that gives clarity to investors and reduces investment risk.

I have set my hopes for real policy change on the European Green Deal. If the European Commission's 'Fit for 55' proposals are to become reality, that would go a very long way in providing an effective carbon price and other supporting policies. Policies that we need to make green investment much more attractive. Indeed, if the recent and sudden large spike in energy prices has learned us anything, it is the importance of switching to more sustainable sources of energy as soon as possible.

Moving on, another barrier to sustainable finance is that green investment projects are often too risky or uncertain for many private capital providers. As said, green investment often involves a relatively high degree of financial uncertainty. It's an ideal investment for providers of venture capital, private equity and investment funds. However, this type of financing is relatively scarce, in particular in Europe. As a result, what you see in mainstream capital markets is that carbon-intensive companies are overrepresented.

The European Capital Markets Union intends to stimulate equity financing and financial innovation for sustainable projects. The European Commission is investigating various options to that effect. I think that's the way forward if we want European financial markets to supply more diverse types of risk capital needed to fund the energy transition. And if we want to do something about the existing carbon-bias in European capital markets.

Next to inadequate carbon pricing, policy uncertainty and the lack of risk capital, there is one last barrier to sustainable finance I want to mention. In addition to investment in relatively young sustainable businesses, the old established businesses also need to invest to reduce their carbon emissions. You find a lot of these businesses in manufacturing, transport, agriculture and construction. As yet they often have insufficient market incentives to reduce emissions. This is due in part to the inadequate carbon pricing I already mentioned, but also because banks and other financial firms that fund carbon-intensive businesses still insufficiently take into account climate-related risks.

As many businesses in Europe depend on bank financing, banks play an important role in financing the transition. That also applies to institutional investors, because they have large investment portfolios, typically with long-term horizons.

Banks, insurance companies and pension funds need to be aware of the climate risks they face. And manage these risks accordingly.

Here financial supervisors, like the central bank of Lithuania and the Dutch central bank, can play an important role. By pushing financial institutions to manage this risk adequately. Just as they do with other risks.

By pressing for good risk management we just do our jobs as supervisors to keep financial institutions safe and sound. But there is an important by-product. Once these institutions have a better understanding of the impact of climate-related risks on their balance sheets, this will impact their investment decisions. Less money will flow to fossil-fuel investments, and more to green investments. This way, financial institutions can become a powerful force in pushing the green transition.

Of course, a big challenge is the lack of good data on the carbon footprint of investments. The information that the financial sector uses is only as strong as the corporate disclosures it is built upon. That is why internationally comparable and mandatory climate-related financial disclosures, that are subject to assurance, are an essential part of our transition to net zero.

The best solution to this problem would be a global solution. Therefore I very much support the work of the IFRS to set up an International Sustainability Standards Board to move towards a harmonized global reporting standard.

But until such a global standard arrives, national governments should not put to one side solutions that work in their respective countries. Don't let perfect be the enemy of the good. The problem is much too urgent for that. In the same spirit, I would call on the financial sector and financial supervisors not to wait for the perfect data. But instead to move ahead with what we've got.

In summary, climate change and other forms of environmental degradation form a major financial stability risk, so central bank involvement is both obvious and necessary. With their independence, their knowledge, their long term view and their focus on risk, they play a key role in providing the facts that help politicians make good decisions. Moreover, by taking that view in their role as financial supervisor, they can help protect the financial sector against climate-related risks and help remove barriers to sustainable finance.

I started by telling you that in the Netherlands we still have a long way to go on the transition path to net zero. In all honesty, I think that bears witness to the fact that there are also limits to the impact central banks can have in this field. But at the same time, there is a lot that they can do. I am sure that without our involvement, matters would have been worse. For example, I know that our research reports, together with those of the Netherlands Environmental Assessment Agency and others, added to the political momentum that led to the national climate law in 2019. I and think we have had a big role in getting climate risk on the radar of our financial institutions.

Being a central banker, let me finish by taking that long-term view once again. After gaining independence more than 30 years ago, Lithuania stood before the enormous challenge of transforming the old communist economy into a modern market economy. The IMF reports at the time labeled the countries in central and eastern Europa as transition economies. I remember that very well from my time as a junior economist at the Dutch central bank.

Thirty years later, we are all transition economies. And maybe only now, we fully realize how much courage it took for Lithuania, and other countries in central and eastern Europe, to embark on their bold experiment. With no blueprint to follow. Under economic circumstances that make our troubles today look relatively benign. But the policymakers back then had little choice. And neither do we today. So maybe we can learn from that generation's experience and take courage from their example. By rising to the challenge, doing whatever it takes to meet the Paris Agreement targets, and tackle climate change in time.