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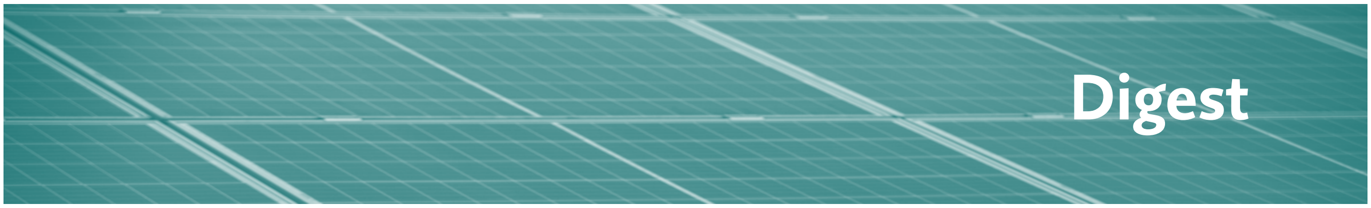

Green Investments and Rising Interest Rates

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Central banks, while raising interest rates, should also address the impact of tight monetary policy on low-carbon investments. Both theoretical and empirical findings suggest that capital-intensive investments in climate mitigation and adaptation are disproportionately negatively affected by a high cost of credit.

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Tobias Schmidt et al. (2019), in "Adverse effects of rising interest rates on sustainable energy transitions", argue that investments in subsidy-free new renewable energy capacity are attractive as long as the levelized costs of electricity (LCOE)[1] of new plants are lower or equal than the short-run marginal costs of the price-setting plants in wholesale markets which are typically fossil fuel plants using lignite, hard coal or natural gas. When interest rates rise, empirical estimates tend to support theoretical findings which indicate that commodity prices in general and energy commodities in particular decrease. As a result, rising interest rates increase the short-run marginal costs of fossil fuel plants. Green investments become less attractive to investors as renewable energy projects still require large up-front costs and are thus much more sensitive to monetary policy. These findings clearly highlight the disproportionately negative effect of tight monetary policy on transition investments.

In their new policy brief "Using green credit policy to bring down inflation: what central bankers can learn from history" **Jens van 't Klooster and Eric Monnet** (2023), argue that:

"Central banks typically associate climate-supporting measures with an expansionary monetary policy stance. Accordingly, such measures are thought to be inappropriate in an inflationary context. Against this view, we highlight a longstanding tradition in central banking which held the contrary: it is desirable to protect some sectors during a tightening cycle because certain types of investment prevent, rather than cause,

inflation."

Van't Klooster and Monnet investigate which green credit policy instruments can be used by central banks that will enable them to address inflationary pressures without jeopardizing the long-term decarbonization of the economy. Toward this end the authors leverage examples of policies implemented by the Bundesbank and the Banque de France, in the years prior to 1990, which illustrate how to design policy instruments that explicitly incorporate allocative criteria. With regard to the low-carbon transition, the policy instruments central banks can use while fighting inflationary pressures are: a) green refinancing credit, b) green asset purchases, and c) green reserve requirements. Van't Klooster and Monnet, finally warn that coordination with other policymaking bodies is key to ensure democratic accountability and prevent credit policy decisions that are inconsistent with the government's efforts toward environmental sustainability.

Yannis Dafermos et al. (2023), in "Broken promises: The ECB's widening Paris gap", point to a different policy implemented by the ECB, in the course of tightening monetary policy, that adversely affects green investments: with the end of net reinvestment of the Corporate Sector Purchase Programme (CSPP), the ECB's efforts to decarbonize its corporate bond holdings effectively stopped, while, at the same time, the Eurosystem has partially reinvested money on carbon-intensive assets. As these decisions are in clear violation of the Paris Commitments, the authors call for the ECB to resume the rebalancing of its bond portfolios towards green alternatives. In a January 2023 speech , ECB board member Isabel Schnabel lent credence to the conclusions reached by Dafermos et al. by arguing that "absent any reinvestments, actively reshuffling the portfolio towards greener issuers would need to be considered". Such reshuffling of the CSPP could also actively protect clean energy investments from interest rate shocks.

Notes

[1]The levelized cost of electricity (LCOE) is a measure of the average net present cost of electricity generation for a generator over its lifetime.

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