e-axes FORUM

Digest

The politics of green financial policies

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In thinking about how to approach a green transition, we need to think not only about economics but also about politics. The role of the state and its public institutions is of central importance in such a transition, however, the redistribution of existing sources of funding and the creation of new sources of credit can be politically contentious. In addition, any policy proposals must be attentive to the possibilities and limitations of different institutions in different national settings. What kinds of green financial policies are both institutionally and politically feasible?

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Divergence between FED and ECB

In a recent working paper, **DiLeo, Rudebusch, and van 't Klooster** (2023) examine the politics of central bank climate policies at the Federal Reserve (Fed) and the European Central Bank (ECB). While the Fed was later to address climate change and has since taken a restrained approach, avoiding any move that may be perceived as an attempt to influence the relative cost or availability of credit to certain activities, the ECB has instead pursued a proactive approach that has seen it explore policies that seek to do exactly this (though, with some limitations). They show that while European central bankers have been supported by think tanks and later governments to address climate change, Fed officials have been held back by political uncertainty and, through Congress, the influence of the fossil fuel lobby. This divergence is particularly notable because of the historical similarities between the Fed's and the ECB's approaches to central banking. **The authors demonstrate how different domestic political features and emerging norms in the international central banking community influence central banks at different points in time.** They provide a political account of central bank policymaking, with implications also for processes of international central bank diplomacy on climate-related policies going forward.

Constraints to green central banking

Several other recent papers have provided theoretical frameworks for understanding the political-economic considerations of financing a green transition, both for central banks and a broader range of public and private financial institutions

Bailey and Jackson (2023) focus on central banks, reviewing the existing literature and setting out a research agenda going forward for considering how variation in institutional, political, and structural constraints in different national settings is likely to shape the policy scope for green central banking. In doing so, they combine the 'green state' literature, which has focused on an environmental transformation of political institutions, often neglecting central banks, with institutional political economy approaches, which have examined how organizations like central banks manage the trade-offs between competing objectives such as climate change and rising inflation.

Beyond monetary policy

In a new working paper, **Gabor and Braun** (2023) look beyond just central banks, situating different types of state approaches to a green transition within different macro-financial contexts. They argue for a state-centered taxonomy of three types of green macro-financial regimes: (i) derisking (with weak and robust versions), (ii) carbon shock therapy, and (iii) the 'big green state'. These macro-financial regimes are the 'combinations of monetary, fiscal, and financial institutions that shape the creation and allocation of credit/money, and hence the speed and nature of the green transition' (p. 3). The derisking state seeks to mobilize private capital by redistributing risks from private investors to its own balance sheet, either by altering the risk-return profile on infrastructure assets (weak), or by creating new industrial assets themselves (robust). While carbon shock therapy places carbon prices alone as central, the 'big green state' is defined by state-led planning for a green transition across sectors, focusing not on private-sector incentives but instead directly mandating investment. Integrating a diverse set of literatures that considers features from geopolitics to macroeconomic ideas to developmental states, the authors argue that the structural and infrastructural power of finance is the main political impediment to the emergence of a big green state.

Green financial division of labor

Murau, Haas and Guter-Sandu (2023) look at a green financial division of labor in the US between different authorities, contributing a framework for understanding how green credit can be best provided by different types of public and private financial institutions at different points in time. The authors distinguish between 'firefighting' central bank and treasury balance sheets versus 'workhorse' public investment agencies and government-sponsored enterprises along with private institutions like commercial and shadow banks. They propose that public 'workhorse' investment agencies are best positioned to provide an initial balance sheet expansion, followed by private banks and shadow banks (though some caution is warranted here), while 'firefighter' central banks should focus on managing financial instability related to a green transition. This paper combines a macro-financial perspective focusing on available monetary space and balance sheet hierarchies across a broad range of financial institutions with an eye on the historical and institutional features that make green credit expansion more or less viable at these different institutions over time.

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