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SHOULD CENTRAL BANKS PLAY A GREATER ROLE IN DRIVING SUSTAINABLE DEVELOPMENT?

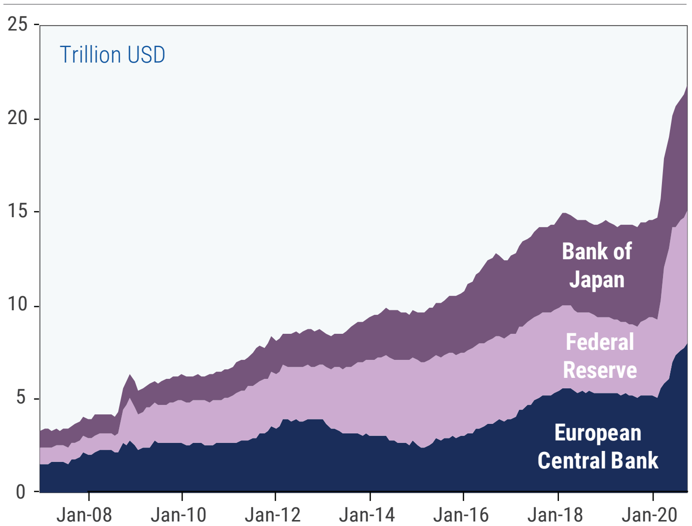
As the COVID-19 pandemic outbreak in March 2020 threatened to drag the global economy into a deep and protracted crisis, central banks once again became the first line of defense for countries across the world.[1] In 2020, about 94 monetary authorities have cut their policy rates, often at emergency meetings. Amid acute stress in financial markets, central banks also swiftly deployed a wide range of policy measures, aimed at preventing a liquidity crunch and supporting credit flows.

With interest rates near the zero bound, central banks in the major developed economies largely responded to the crisis through the introduction of quantitative easing measures on an unprecedented scale. The United States Federal Reserve (Fed) announced an unlimited purchase of government-backed debt, and also started to buy corporate bonds for the first time. The Bank of Japan also pledged to buy an unlimited amount of government bonds, while accelerating its purchase of risky assets, including exchange-traded funds and corporate bonds. In addition, the European Central Bank (ECB) launched an emergency bond-buying programme, while easing collateral standards and expanding the range of eligible assets. These measures led to the expansion of central bank balance sheets to record highs (*Figure 1*).

Among the developing economies, the severity of the shock prompted several central banks to introduce unconventional monetary policy measures. Central banks, including in Chile, the Republic of Korea, Turkey, and South Africa, launched inaugural asset purchase programmes that were mainly geared towards the outright purchase of government bonds. Unlike the developed countries, however, asset purchases by most developing countries were not explicitly aimed at providing credit support. Rather, they were targeted at addressing financial market dislocations due to heightened risk aversion, and served as a signal of central banks' willingness to undertake the role of buyer of last resort.[2]

1 This Monthly Briefing article is largely adapted from the section titled "Should monetary policy play a greater role in promoting sustainable development?" in the United Nations Report of the Secretary-General on Towards a new international economic order, A/75/325.

Figure 1
Total assets of major central banks



Source: National authorities.

The post-pandemic global landscape will be characterized by structurally weaker economies and more limited fiscal space

Central banks' rapid and aggressive policy actions were pivotal in reversing most of the financial stress caused by the pandemic. Complemented by sizeable fiscal stimulus packages, central banks' liquidity injections helped to prevent negative feedback effects between the financial system and real economic activity. However, while a deeper crisis has been averted in the immediate term, central banks are facing an increasingly challenging operating environment, characterized by structurally weaker economies, greater uncertainty, and more fragile financial systems. This new post-crisis reality may force a rethink of the role of central banks and monetary policy.

The pandemic has exacerbated existing domestic vulnerabilities in many countries, inflicting long-lasting damage on growth and development prospects. Massive job losses due to the crisis has pushed millions into poverty, especially in countries without adequate social safety nets. The disproportionate effects of the pandemic on low-skilled and low-wage jobs will also lead to wider income inequality. Amid the collapse in global demand, the outlook for global investment has darkened, exacerbating headwinds to productivity growth. Importantly, as governments focus on addressing a multitude of short-term risks, efforts to combat climate change and accelerate the transition toward clean energy could take a backseat over the next few years.

While vital to avoid economic collapse, large fiscal interventions over the past year have left many governments with

2 Aslan et al. (2020), "Central bank bond purchases in emerging market economies," BIS Bulletin No. 20, Bank for International Settlements.

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record-high debt burdens, raising concerns over public debt sustainability going forward. The situation is particularly precarious among the more vulnerable developing economies, including the least developed countries and small island developing States, an increasing number of which are at high risk or are already in sovereign debt distress. Given significantly weaker budgetary positions, a large number of countries do not have sufficient fiscal capacity to respond effectively should another large shock hit the economy. In addition, many governments will struggle to finance much needed investment in key areas of sustainable development, such as health, education, physical and digital infrastructure, and energy transition.

Should central banks play an active role in driving sustainable development?

As fiscal space narrows across countries, a key question is whether central banks should play a greater role in promoting sustainable development going forward. Since the global financial crisis, central banks have consistently demonstrated their ability to rise to the occasion, pushing far beyond conventional monetary measures in order to restore market stability and support short-term growth. With the vaccine breakthrough offering hope of a foreseeable end to the pandemic, countries are now turning their attention towards designing policy strategies to build back better. In this aspect, there is potential for central banks to contribute more towards a stronger and more inclusive recovery. This could possibly be achieved through the integration of sustainable development considerations into monetary and financial policy decisions.

It is widely argued that central banks should not directly pursue sustainable development objectives as this expansion in responsibility could reduce their effectiveness in pursuing traditional mandates. Out of a sample of 135 central banks across the world, only 12 per cent have mandates that explicitly include sustainable development as an objective, while a further 40 per cent play a role in supporting their governments' development policy agendas.[3] However, a growing number of central banks are acknowledging the need to respond to non-economic risks and other sustainable development issues. In Asia and the Pacific, 94 per cent of central banks surveyed believed that they should play a role in promoting green finance.[4] The ECB also recently raised the possibility of abandoning the 'market neutrality' principle in its corporate bond purchases, to address the under-pricing of climate risk.

Rising sustainable development challenges can indeed directly affect central banks' core objectives of preserving price and financial stability. The increasing effects of climate change, including more frequent weather shocks and natural disasters, could cause shortages of food and energy, exerting upward pressure on inflation. In addition, more restrictive climate-related government regulations could result in a sharp repricing of assets exposing financial institutions to large losses and threatening financial stability.

Growing interest in central banks' purchase of assets that promote sustainable activity

In recent months, many developed countries expanded their quantitative easing programmes to include the purchase of corporate assets across a broad range of sectors. However, it is important to note that central banks across most countries have long been purchasing private financial assets as part of their reserve portfolios. In devising future asset purchase strategies, central banks could give preference to assets that promote sustainable development, such as green bonds and social impact bonds. This would be an answer to growing calls for central banks to engage in social impact investment, including in the areas of affordable housing, renewable energy, and micro-finance. In 2019, the Bank for International Settlements (BIS) launched a green bond fund, aimed at helping central banks to incorporate environmental sustainability objectives into their reserve management frameworks.[5] In addition, Sheng (2015)[6] noted that if central banks were to join the United Nations Principles for Responsible Investment (PRI)[7], an estimated $22 trillion worth of funds would be added to the $44 trillion of assets under management according to these Principles. Currently, the central banks of Finland and the Netherlands are the only two central bank signatories of the PRI. A BIS study highlighted that the inclusion of sustainable investments in reserve portfolios need not be at the expense of safety and return, and could instead generate diversification gains for central banks.[8]

Role of prudential policies and financial regulation

Central banks are also being increasingly called upon to utilize prudential policies and financial regulation to steer financial resources towards more productive and sustainable economic activity. In the aftermath of the global financial crisis, many central banks, particularly in Asia, introduced measures aimed at curbing speculative investment in targeted sectors, including equity and property markets. Today, the emergence of new sources and transmission of risks could necessitate a further differentiation in central banks' regulation frameworks. Notably, increasing physical, transition and liability risks due to climate change are

3 Simon Dikau and Ulrich Volz (2020), "Central bank mandates, sustainability objectives and the promotion of green finance", Working Paper No. 232, SOAS University of London.

4 Asian Development Bank, "The role of central banks in scaling up sustainable finance: What do monetary authorities in Asia and the Pacific think?", ADBI Working Paper Series No. 1099, March 2020.

5 BIS, "BIS launches green bond fund for central banks", 26 September 2019.

6 Sheng (2015), "Central banks can and should do their part in funding sustainability", Fixing Climate Governance Series, Paper No. 1, June 2015, Centre for International Governance Innovation.

7 The United Nations Principles for Responsible Investment is an international organization that promotes the incorporation of environmental, social, and corporate governance factors into the investment decisions of their signatories.

8 Fender et al. (2019), "Green bonds: The reserve management perspective", BIS Quarterly Review September 2019, Bank for International Settlements.

posing a growing concern for policymakers, given their potential systemic implications on financial systems and on sustainable growth. In 2019, the Network for Greening the Financial System[9] published a set of recommendations to facilitate the financial sector's management of climate risks. This includes assessing financial institutions' exposure to "brown" and other unsustainable assets, as well as incorporating climate risks into bank stress tests. In addition, while some companies have begun to report the potential financial impact of climate risks on their balance sheets, this disclosure remains voluntary in nature. In this aspect, there have been calls for central banks to make sustainability reporting mandatory for financial institutions.

Enhancing the availability of financing for development

In response to the sharp impact of the pandemic on household and businesses, many central banks launched loan programmes to channel funds to small and medium-sized enterprises (SMEs). Looking ahead, the continued provision of financial resources not only to SMEs and micro-borrowers, but also to specific industries, will be essential in ensuring a more sustainable and inclusive recovery. Central banks can play a greater role in designing specialized credit programmes for SMEs, which could also be made conditional on these businesses creating jobs in sustainable areas.[10] Based on the experience of several developing countries, such as India, Malaysia, and Thailand, priority sector lending policies can improve access to credit for underserved sectors. Central banks could also introduce a differentiation in lending rates, requiring banks to offer lower borrowing costs to sectors that promote sustainable growth, such as sustainable agriculture and rural infrastructure, and renewable energy. These measures could not only enhance financial inclusion, but also support efforts towards poverty eradication and meeting environmental targets.

Risks and policy challenges

While there are many policy options for central banks to promote sustainable outcomes, a move in this direction could entail significant challenges and risks. The most widely discussed concern is that the further expansion of central banks' mandates could affect their effectiveness in achieving their primary goals of price and financial stability. Regulations that attempt to steer private financial flows to specific sectors, such as renewable energy, could distort financial markets and affect financial stability. In addition, overstretched central bank mandates may not only reduce policy effectiveness, but also generate unintended spillovers on other sectors in the economy. For instance, the use of unconventional monetary policies during the global financial crisis to support demand also contributed to stronger capital volatility while leading to an increase in indebtedness. Central banks' pursuit of sustainable development could also raise questions over their accountability and independence, thus undermining the credibility of the institution. In particular, overlapping responsibilities with other government agencies could trigger concerns over political influence over the central bank.

Amid a very challenging post-pandemic landscape, increasing demands on central banks will require some changes to the way they currently operate, to maintain credibility and policy effectiveness. In particular, discussions over accountability and governance structures are likely to grow. An improvement in transparency could help to enhance central bank accountability. In addition, clear and consistent communication will be key in helping the public to better understand the motivation behind new policy actions.

9 The Network for Greening the Financial System is a network of central banks and supervisors that aims to share the best practices in integrating climate risks into financial sector policies.

10 Anis Chowdhury (2018), "Monetary policy for inclusive and sustainable development", Dialogue of Civilizations Research Institute.