Rothschild & Co
Asset Management

ESGnomics

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Foreword

Climate change, reduced inequality and better governance are all challenges to making our world more just and sustainable in the future, and Rothschild & Co is committed to this goal.

The Group's economic research is part of this approach, providing analysis on the main risks and opportunities to which economic players are exposed. ESGnomics aims to convey in an educational manner the contributions of economics to the discussion of Environmental, Social and Governance issues.

Central banks and climate: challenges and levers for action

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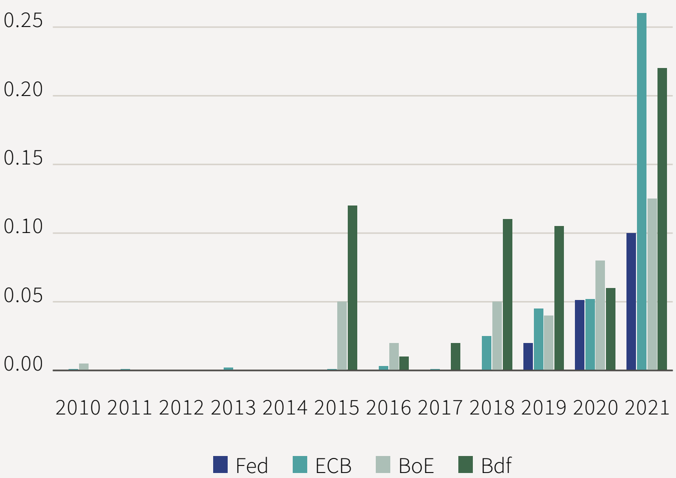
As we discussed in a previous edition, the need for central banks to mobilise in the fight against climate change is legitimate. However, they do face some constraints in using the tools at their disposal.

World – Speeches on climate change
in %, given by central bankers



Source: DiLeo, Brookings, BRI, Rothschild & Co Asset Management, 2024.

A legitimate interest for central banks

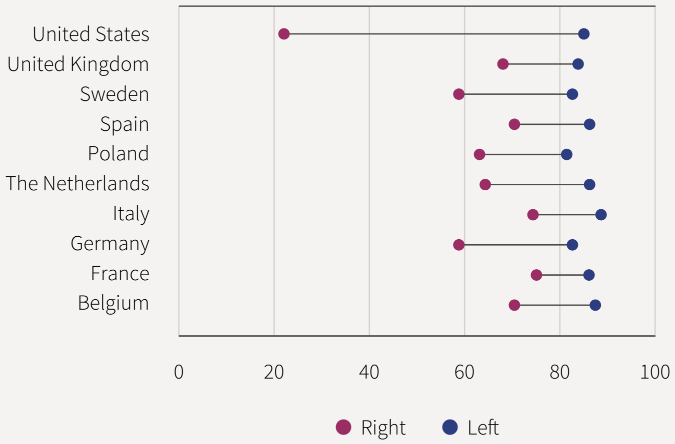
Climate disruptions and transition policies will have a significant impact on economic activity, present and future. Accordingly, contributing to assessing, reducing, and managing the impact of climate risks on the real economy and the financial system is an integral part of the mandate of central banks and supervisors.

> “Climate disruptions and transition policies will have a significant impact on economic activity...”

(1) ONUDC, "Corruption et mauvaise gouvernance", 2017.

World – Political polarization on climate

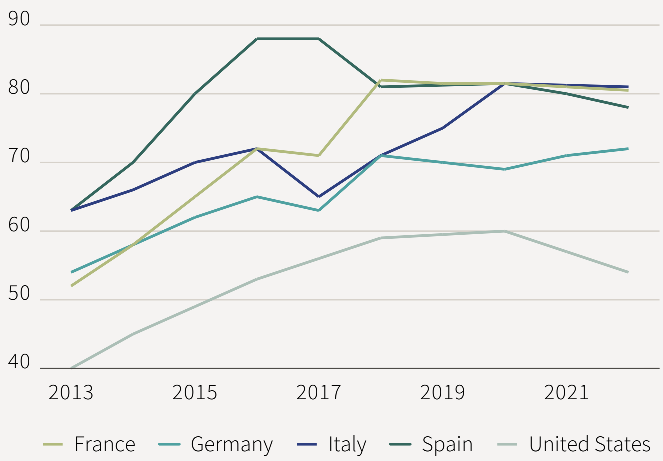
in %, climate change as a major threat



Source: Pew Research Center, Rothschild & Co Asset Management, 2024.

World – Awareness of climate change

in % designating it as a major threat



Source: Pew Research Center, Rothschild & Co Asset Management, 2024.

> "the Fed is more reluctant than the ECB to take measures that are openly geared to combating climate change,... "

Fed and ECB: two visions

Several factors are shaping central banks' attitudes on both sides of the Atlantic.

First, the mandates of the Fed and ECB have specific legal features that will influence their actions. While the ECB's main goal is price stability, a broad reading of European treaties shows that its must also support the general orientation of the European Union's economic policies, which encompass environmental goals[1]. This allows the ECB to take environmental criteria into account in the conduct of its monetary policy.

However, the Fed's dual mandate is clear and precise: price stability and full employment, which excludes combatting climate change as an explicit goal[2]. Until now, these legal differences have resulted in a more proactive attitude by the ECB in addressing climate risks[3].

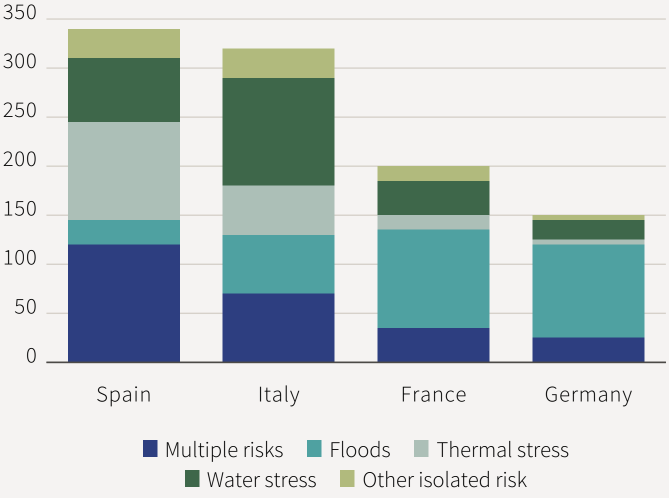
Furthermore, despite independence acquired in recent decades, central banks' attitude has been influenced by the political context in which each of them operates.

Varying views of climate issues, for example, are an implicit constraint. In the US, climate change remains an extremely polarising issues between Democrats and Republicans, and, more generally, the US is one of the countries that pays the least attention to environmental risks. No wonder that the Fed ignores this issue as much as possible in the conduct of its monetary policy in order to avoid criticism. In contrast, climate change is a far less divisive issue in European public opinion[4].

In short, despite clear risks, the Fed is more reluctant than the ECB to take measures that are openly geared to combating climate change, in order to preserve its credibility and independence while shielding itself from political controversies.

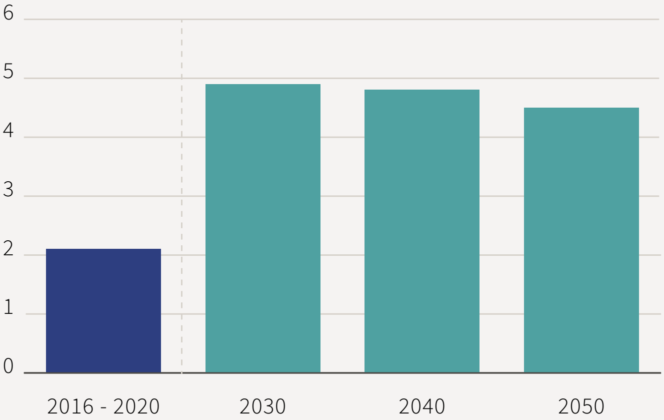
(1) Article 127, Treaty on the Functioning of the European Union
(2) Section 2A of the Federal Reserve Act
(3) DiLeo *et al.*, "Why the Fed and ECB Parted Ways on Climate Change: The Politics of Divergence in the Global Central Banking Community, Brookings Institution, 2023
(4) Poushter *et al.*, "Climate Change Remains Top Global Threat Across 19-Country Survey", Pew Research Center, 2022

EZ – Banks' exposure to physical risks
in billions of EUR



Source: ECB, Rothschild & Co Asset Management, 2024.

World – Capital investments - Net Zero 2050
thousand billion USD, annual average, energy sector



Source: International Energy Agency (IEA), Rothschild & Co Asset Management, 2024.

What are the levers for action?

Central banks may use three types of action levers.

First, climate risk supervision focuses on understanding and managing risk. The main example of this is the climate stress test. In overseeing the robustness of the financial system, central banks attempt to measure banks' capacity for resilience to transition scenarios and climate risks. The goal is to strengthen their capacities to collect data and analyse these risks, and to incentivise them to take remedial measures[5].

Second, central banks may take measures regarded as more proactive, steering existing monetary policy tools towards a goal of combatting climate change. The ECB's decision to gradually "green" its corporate bond portfolio is one such example[6]. However, the monetary tightening that it began in 2022 came with an end to its asset-buying programme. As a result, the ECB nolonger has any tangible way to green its portfolio. The greening decision was therefore symbolic and cannot be regarded as a permanent lever of action in combatting climate change.

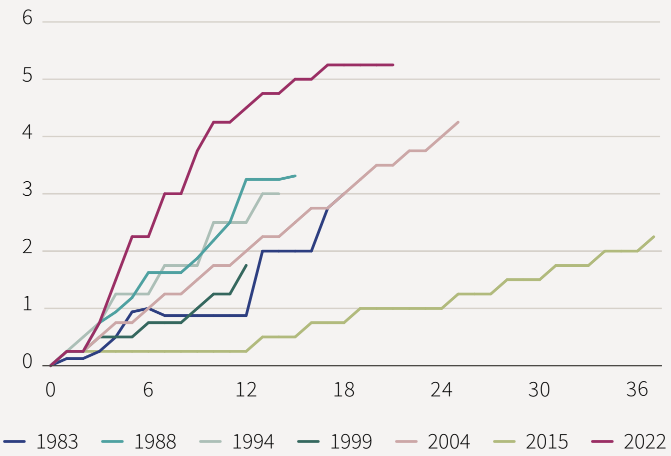
And, lastly, one alternative path would be to focus on central bank reforms involving a shift in the current manner of conducting monetary policy. This could be in the form of a targeted credit allocation policy with the goal of greening the economy. For the moment, no central bank has gone down this path. We will discuss this further in a coming edition.

> "central banks attempt to measure banks' capacity for resilience to transition scenarios and climate risks.... "

(5) ECB, "2022 climate risk stress test", 2022
(6) This programme consisted in assigning a climate score to companies in the bond-selection process and in rebalancing the portfolio by gradually increasing the weighting of highly-scored bonds.
"ECB takes further steps to incorporate climate change into its monetary policy operations", 2022

US – Fed funds rate

in % per month after the first hike



Source: Macrobond, Rothschild & Co Asset Management, 2024.

Goals that sometimes run at cross-purposes

While central banks possess action levers to combat climate change, the actual impact of such measures should be kept in perspective. Indeed, the monetary tightening policies set up since 2022 have shed light on a sizeable issue – the paradox between short-term vs. the long term price stability.

Amidst a broad increase in prices, central banks are guided by the absolute need to tame inflation. To do so, they raise their key rates.

However, given the huge long-term investment needs[7], higher interest rates are keeping some projects from being launched and are thus delaying the environmental transition. Paradoxically, in fighting short-term inflation, central banks are promoting greater volatility in long-term inflation, due mainly to "climateflation", "fossilflation" and "greenflation"[8]. This is causing them a true problem of timing in the conduct of their monetary policy.

Risks related to climate change

- **Physical** risks
- **Transition** risks

Disruption of the economic and financial system

- Highly **volatile** inflationary environment
- **Economic losses** linked to climate disasters and transition policies
- Downward impact on **GDP and potential growth**

Challenges for monetary policy

- Anticipate shocks and develop credible monetary policy
- Balance short-term price stability with long-term green investment needs
- Adopt green action standards while ensuring the independence of central banks from political influence

(7) International Energy Agency, "Net Zero Roadmap: A Global Pathway to Keep the 1.5 °C Goal in Reach", 2023
(8) ESGnomics n°8

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As the specialised asset management division of the Rothschild & Co group, we offer personalised asset management services to a broad client base of institutional investors, financial intermediaries and distributors. Our development is focused on a range of open-ended funds, marketed under four strong brands: Conviction, Valor, Thematic and 4Change, and leveraging our long-term expertise in active management with conviction as well as in delegated management. Based in Paris and established in 9 European countries, we manage more than 26 billion euros and employ nearly 160 people. More information at: www.am.eu.rothschildandco.com

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