Forging the Future: Pioneering Approaches in Business, Management and Economics Engineering to Overcome Emerging Global Challenges - 2024

https://doi.org/10.24867/FUTURE-BME-2024-003 Invited lecture

CAN ESG PRINCIPLES CONFLICT WITH CENTRAL BANK POLICIES?*

Fabris Nikola[1] *[0000-0001-9500-1943], Radoica Luburić*[2] *[0009-0006-5991-8002]*

Abstract

Today, the implementation of ESG principles has become a topic of great importance, discussed in expert forums, political events, national economic policy debates, the media, and elsewhere. International institutions, non-governmental organizations, legislators, the media, and others are exerting significant pressure for the implementation of these principles. Generally speaking, Central banks are among the leading institutions in the implementation of ESG principles.. They adhere to them not only to maintain financial stability but also to manage reputational risk and set a good example. However, what is often overlooked is that the implementation of these principles carries numerous challenges and even risks for central banks. There can be a conflict between policy objectives and ESG objectives. Therefore, the question arises as to how central banks can reconcile these two objectives or how to find a trade-off. Very few studies address this issue. Therefore, the focus of this paper is on a balanced consideration of the need to implement these principles in central banks, the challenges their implementation brings, as well as the risks and potential conflicts with the core mission of central banks.

Key words*: central banks, ESG principles, chalenges, policy goals***.**

1. Introduction

Environmental, Social, and Governance (ESG) principles have become increasingly important in the financial sector, including central banking. Integrating ESG principles in central banking involves considering environmental sustainability, social responsibility, and sound governance in formulating and implementing

[1] Faculty of Economics and Business, Belgrade University; Central Bank of Montenegro, Montenegro, nikola.fabris@cbcg.me

[2] Central Bank of Montenegro, Montenegro, radoica.luburic@cbcg.me

* The views and opinions expressed herein are those of the authors and do not necessarily reflect the official policy or position of any institution or organization.

monetary policy, ensuring financial stability, and supervising banking operations. These principles are gaining importance as central banks play a crucial role in maintaining financial stability and promoting sustainable economic growth.

Environmental (E): This principle involves addressing ecological issues such as climate change, pollution, conservation of natural resources, and biodiversity. Central banks can influence the reduction of environmental risks by adjusting their investment portfolios, supporting green financial instruments, and promoting sustainable practices among financial institutions.

Social (S): This principle pertains to social issues such as labor rights, equality, health, and social security. Central banks can contribute to social responsibility through initiatives that promote financial inclusion, support minority and marginalized groups, and encourage the financial system to support balanced and sustainable economic development.

Governance (G): This principle encompasses corporate governance issues such as transparency, accountability, integrity, and ethics. Central banks can enhance corporate governance by applying strict standards in their operations and promoting the same standards throughout the financial system.

The key challenges that central banks face in implementing ESG principles include: lack of specialized knowledge and skills; insufficient, comprehensive, reliable, and granular comparable data; lack of standardization; lack of awareness of ESG concepts; and difficulty integrating ESG concepts with organizational culture (Magalong & Chamoun 2024). The challenge also lies in the traditional internal structure of central banks, which needs to be further integrated with engineering expertise, the collection of new data, the establishment of internal bodies dedicated to the ESG agenda, as well as increasing management's knowledge of these issues.

Today, there is a growing number of international organizations dedicated to implementing these principles in central banks and the financial system, such as the Network for Greening the Financial System, the Financial Stability Board, the International Financial Reporting Standard Foundations, the Task Force on Climate-related Financial Disclosures, and the Sustainable Banking and Finance Network, among others.

The primary goal of this paper is to analyze whether the implementation of ESG principles might conflict with the mission of the central bank and to offer appropriate recommendations. This issue has been rarely explored in the literature, and when it has, it has been almost exclusively from the perspective of the impact of climate change and the central bank's investment policy. Other aspects, to the best of the authors` knowledge, have hardly been extensively analyzed.

This paper consists of five parts. After the introductory remarks, the second part discusses the impact of ESG principles implementation on monetary policy and key central bank functions. The third part of the paper deals with social responsibility, while the fourth part provides some policy recommendations, and The final part of the paper presents concluding considerations.

2. Monetary Policy and Implementation of ESG standards

Inflation – Central banks primarily focus on short-to medium-term price stability, which can conflict with the long-term horizon of ESG goals. A focus on ESG can lead to substantial investment in green technologies and infrastructure, potentially at the expense of more traditional industries. While this can promote long-term sustainability, the short-term impact may include increased costs and price volatility.

For instance, transitioning from fossil fuels to renewable energy sources can raise production costs, which may be passed on to consumers, leading to higher inflation. Companies adjusting their supply chains to align with ESG standards might face disruptions and increased costs, affecting the prices of goods and services. This can also result in volatility in financial markets and shifts in asset prices, impacting overall economic stability and price levels.

However, from a long-term perspective, abandoning ESG principles can lead to even higher inflation and increased costs. For example, continuing to use fossil fuels may result in higher costs for mitigating the consequences caused by their production (higher healthcare costs, more expenses for recovery from frequent natural disasters, higher environmental protection costs, etc.). On the other hand, with greater adoption of green technologies, their further development will occur, thereby reducing their costs.

Central banks might need to balance the trade-off between supporting ESG goals and maintaining price stability. For example, if inflation rises due to ESG-related cost increases, the central bank might face a dilemma between raising interest rates to control inflation and supporting investment in green technologies, which might require lower interest rates. Achieving this balance will be crucial for central banks as they navigate the evolving landscape of sustainable finance and its implications for economic policy.

Investment policy – As part of their investment policies, central banks may choose to invest in ESG bonds. However, investing in these bonds presents numerous challenges for central banks. Firstly, there is no clear classification of what constitutes an ESG bond, as standardized data on the “greenness” of both issuers and assets is lacking. The absence of a clear definition increases the risk of greenwashing. Additionally, the liquidity level of these bonds is significantly lower compared to traditional bonds. This can conflict with central banks' investment policies, which require a high level of liquidity for a significant portion of their portfolios to ensure the smooth implementation of monetary policy instruments. According to OMFIF (2019), these bonds account for less than 2% of global debt issuance. Furthermore, due to their nature, these bonds are often issued with very long maturities, which may be too long relative to the investment policies of central banks. Lastly, these bonds frequently offer lower returns compared to traditional bonds. The World Bank`s primer (2021) suggests that ESG investment strategy incorporated into the reserve management framework should align with institutional objectives and apply to the existing set of eligible asset classes. We believe that potential trade-offs between central banks` investment policies and

these investment challenges can be managed by allocating a portion of the central banks investment portfolios to green bonds, continually reviewing this portfolio, and setting interim targets.

Climate change – Climate change represents one of the most significant global risks. Estimates indicate that the consequences of climate change will have an increasingly negative impact on annual GDP, ranging from up to 3.3% by 2060 to 12% by 2100 (Fabris & Luburić, 2022). While there may have been past debates about whether climate change falls within the mandate of central banks, today there is no doubt about it as climate change can be a source of financial risks, and managing all types of financial risks falls under the mandate of central banks in their role of preserving financial stability. Central banks have the responsibility to identify climate-related risks, ensure that these risks are incorporated into banks` risk management policies, and monitor the resilience of banks to climate risks. As socially responsible institutions, central banks also aim to influence and raise social awareness about climate risks.

In 2019, the European Central Bank (ECB) identified climate risks as one of the key threats facing the banking sector (OMFIF, 2019). In November 2020, it published the Guide on Climate-Related and Environmental Risks for banks, along with stress testing focused on climate-related risks. The European Banking Authority has recently published its roadmap to enhance ESG regulations in progress. Over a three-year horizon, this roadmap aims to incorporate all ESG principles into the regulatory frameworks for banks (Delgado, 2023).

The first step in supervising these risks is to understand their source, size, and likelihood. Climate change impacts the banking system through four channels, three of which are negative (physical, transition, and indirect) and one of which can have a positive impact.

Physical Risk: This occurs with weather-related events. Financial institutions can be affected directly by physical risk through the reduced value of assets and collateral, increased insured damages, or disruption of their own business operations. They can also be affected indirectly through their portfolios as credit risk and market risk.

Transition Risk: This financial risk arises from adjusting to new environmentally acceptable business techniques or the introduction of business restrictions for companies that contribute to greenhouse gas emissions.

Indirect Risk: This risk, often overlooked in scientific studies, occurs in companies whose business is not directly affected by climate change, but whose key partners are at risk.

Positive Impact: The transition path poses challenges but also opportunities. Positive impacts can occur through the emergence of new companies that become leaders with their innovations, displacing companies using environmentally unacceptable standards. This channel can also result from increased social awareness, leading the population to avoid producers who use techniques and technologies contributing to climate change.

The following figure illustrates the interdependencies and channels of the climate change impact on the banking system and economic growth.

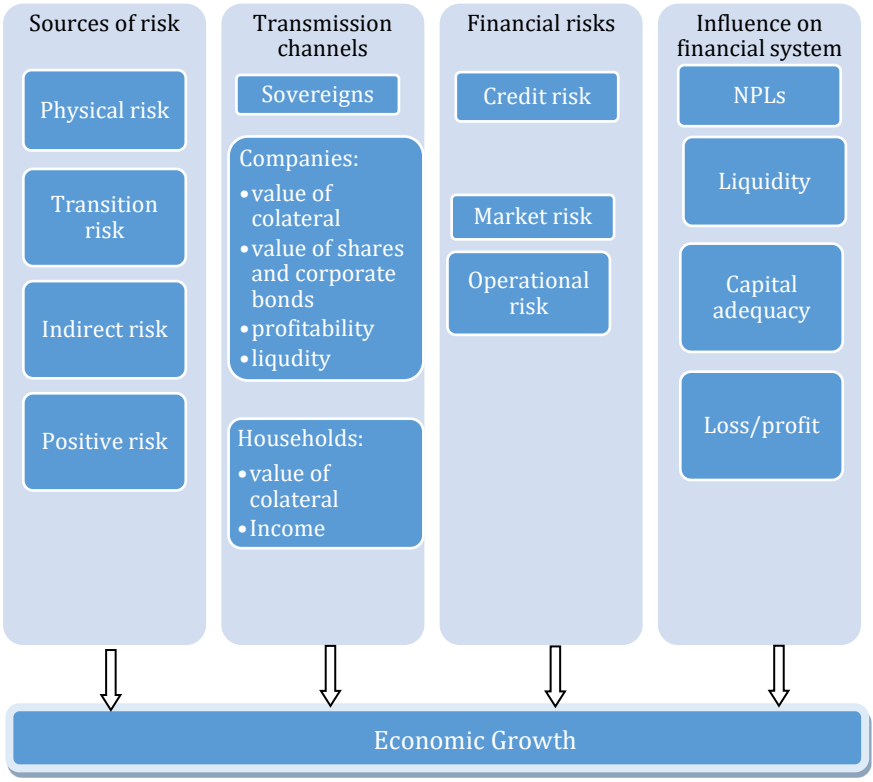

Figure 1: Climate change impact on the banking system

Source: Fabris, 2020.

Climate change can negatively affect the transmission mechanisms of central banks. It can make banks less willing to extend credit to the economy. In such cases, a reduction in the interest rate might be insufficient to stimulate the economy if inflation is below target (UNCTAD, 2023). Given that there is no doubt that climate risks must be managed, the following graph presents a climate risk management model.

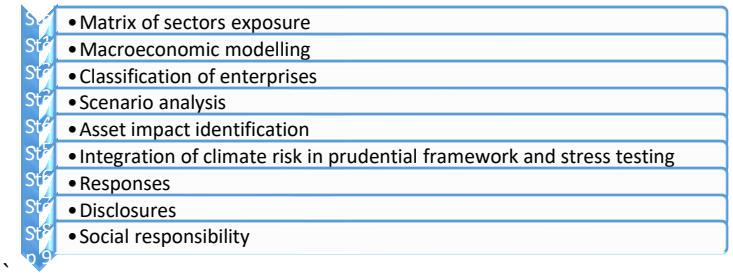

Figure 2: Climate risk management model

Source: Fabris, 2020

Central banks, in their role as regulators, can require financial institutions to disclose ESG risks and incorporate these risks into their lending and investment decisions. This can lead to a more resilient and sustainable financial system. Due to their capacity, independence, and overarching role, central banks should take on the role of coordinating the implementation of ESG principles in the financial sector and beyond. This would also imply a certain departure from the traditional position of central banks.

3. Social Responsibility and Governance

Central banks are institutions that place significant emphasis on social responsibility. In this segment, apart from a few minor exceptions, there is no conflict with the ESG agenda. Central banks can support inclusive growth by ensuring that monetary policies promote employment and equitable access to financial services. Addressing income inequality and fostering financial inclusion can enhance social stability and economic resilience.

Central banks have a role in promoting financial literacy and consumer protection, which are essential for the well-being of the community. The level of financial literacy is very low in many countries, making it common practice for central banks to act as umbrella institutions that develop strategies to enhance financial literacy. Financial education helps to promote financial inclusion, boost the economy, reduce the level of unmanageable debts, and reduce poverty levels (Luburić & Fabris, 2018).

Incorporating social considerations into central banking policies can also mean advocating for fair labor practices and human rights, indirectly influencing broader financial and corporate sectors to adopt similar standards. Additionally, social responsibility for central banks means that they should engage in supporting a wide range of civil society projects, which may not be directly within the central bank's mandate but have a significant impact on civil society development.

Initiatives to improve wages and working conditions can also lead to increased production costs. While beneficial for social welfare, these costs might be transferred to consumers, potentially causing price increases. If wage increases are aimed at ensuring a normal standard of living for vulnerable groups, central banks

should not view this as conflicting with their mission. However, if wage increases exceed productivity as a result of a political agenda, then a clear conflict arises. Additionally, implementing and maintaining high governance standards can entail significant compliance costs, which might again be reflected in consumer prices.

Moreover, adopting ESG principles promotes greater transparency and accountability in central banking. The importance of transparency in central banking is immense, and more people are recognizing that transparency represents a new and distinct instrument of monetary policy (Fabris, 2006; Kohn & Sack, 2003; Bernhardsen & Kloster, 2002). This involves clear communication of policy decisions and their impacts, ensuring that the public and other stakeholders are well-informed and can hold the central bank accountable.

4. Policy Recommendations for central banks

It is evident that the implementation of ESG principles can lead to potential conflicts in the pursuit of central bank policy. To mitigate these, central banks and policymakers can:

Integrate ESG considerations into monetary policy frameworks: By understanding and incorporating the long-term benefits of ESG into their analysis, central banks can better balance short-term price stability with long-term sustainability.

Promote transparency and gradual implementation: Ensuring that ESG policies are implemented gradually and transparently can help mitigate sudden inflationary shocks.

Coordinate with fiscal policy: Central banks can work closely with government fiscal policies to ensure that ESG initiatives are supported without compromising price stability.

Central banks should continuously consider how climate change and other ESG factors might affect economic outlooks, inflation, and financial stability. Additionally, it is important to incorporate ESG risks into regulatory frameworks to ensure that financial institutions adequately manage these risks. Central banks must also require commercial banks to make climate-related disclosures. In some jurisdictions, this reporting is mandatory, but in most, it is still voluntary. This measure is also supported by the European Central Bank (2023). According to the Task Force on Climate-related Financial Disclosures: “Imposing mandatory climate-related disclosures based on an internationally recognised framework will increase the availability of information in the financial markets on how climate change will impact the risks and opportunities faced by companies or their assets” (Central Banking, 2021). Introducing this requirement is certainly a significant challenge, but it appears that there is a greater cost to not having the information and data available to enforce appropriate risk management. However, as highlighted in the Bank of Finland`s annual review (2021), “Good reporting builds trust, promotes openness, and supports the organisation’s work. This is why it also plays a key role in a central bank’s communication.”

Significant global cooperation and coordination are essential, as no single central bank can solve the problem alone. The current approach, where numerous international institutions work individually, is insufficient. Global coordination helps harmonize ESG standards and practices, making it easier for multinational financial institutions to comply and for central banks to compare and assess the effectiveness of their ESG policies. Therefore, we propose that central banks establish an ESG Board to address the following areas:

International Standards in the ESG Area: Developing and aligning global ESG standards.

International Cooperation and Coordination: Enhancing collaboration among international entities.

Status of ESG Implementation: Monitoring and reporting on the progress of ESG initiatives.

Key Performance Indicators: Defining and measuring the success of ESG policies.

Compliance Requirements: Setting and enforcing regulatory expectations.

Challenges and Risks: Identifying and mitigating potential issues.

Effective governance requires engaging with a wide range of stakeholders, including governments, financial institutions, international organizations, civil society, and the public. This inclusive approach enables central banks to better understand and address the diverse needs and concerns of different groups.

5. Conclusion

While ESG principles aim at long-term sustainability, the benefits might not be immediately apparent. There can be trade-offs between different ESG goals, data limitations, and potential conflicts with traditional central banking objectives. Central banks, by adopting ESG principles, can play a pivotal role in steering the global economy towards a more sustainable and equitable future.

The paper demonstrates that the implementation of ESG principles in certain aspects of central banking, particularly in the short-term, may conflict with the central bank's objectives. The authors believe that, in the long-term, their implementation will benefit both central banks and society as a whole, and that careful and coordinated policy design can help balance these objectives, ensuring that long-term sustainability does not come at the expense of short-term economic stability. However, political myopia and the frequent emphasis on achieving short-term goals could negatively impact the implementation of these principles.

Regarding the primary objective of central banks, which is to maintain price stability, the implementation of ESG principles in the short- or medium-term may be conflicting. Central banks may face a dilemma: whether to tolerate higher inflation to encourage green investment or to strictly adhere to their primary objective. We believe that a trade-off should be sought, and that the implementation of ESG principles will bring long-term benefits to society as a whole.

When it comes to investment policy, investing in green bonds can also be conflicting, as these bonds often have lower yields, less liquidity, and a longer investment horizon compared to the investment policies of central banks.

In the context of climate change, the implementation of ESG principles is fully compatible with the mission of central banks, as climate change threatens financial stability and interferes with the functioning of the monetary policy transmission mechanism. Therefore, central banks must ensure that climate change risks are adequately assessed, properly disclosed, and integrated into the risk management of financial institutions.

Central banks are institutions that have traditionally paid attention to social responsibilities. They traditionally promote employment and equitable access to financial services, foster financial inclusion, support financial literacy initiatives, and numerous civil society projects, which is compatible with ESG principles.

The paper also provides recommendations on how to overcome these conflicts more easily, their gradual implementation, and other challenges that may arise.

REFERENCES

[1] Hyrske, A. (2021). *Sustainability is Catching on in Central Banks*. Bank of Finland.

[2] Lee, B. (18. Novembar 2021). *Should ESG Reporting be Made Mandatory?* Central banking. https://www.centralbanking.com/central-banks/governance/7894746/should-esg-reporting-be-made-mandatory

[3] Delgado, M. (2023). The Role of Central Banks in Sustainable Finance. *11th Funseam International Business Symposium, Barcelona.* https://www.bis.org/review/r230427e.pdf

[4] Bouyé, E., Klingebiel, D. & Ruiz, M. (2021). *Environmental, Social, and Governance Investing* (1st edition). World Bank. https://documents1.worldbank.org/curated/en/677271630474233931/pdf/Environmental-Social-and-Governance-Investing-A-Primer-for-Central-Banks-Reserve-Managers.pdf

[5] European Central Bank (2023). Opinion of the European Central Bank of 4 October 2023 on the Transparency and Integrity of Environmental, Social And Governance (ESG) Rating Activities. European Central Bank. https://www.ecb.europa.eu/pub/pdf/legal/en_con_2023_30_en.pdf

[6] Fabris, N. (2006). *Centralno bankarstvo u teoriji i praksi* (1st edition). Central Bank of Montenegro.

[7] Fabris, N. (2020). Financial Stability and Climate Change. *Journal of Central Banking Theory and Practice*, *9*(3), 27–43. DOI: 10.2478/jcbtp-2020-0034

[8] Fabris, N., & Luburić, R. (2022). Climate Change and Quality of Life. *X International Conference "Quality System Condition For Successful Business And Competitiveness"*, Kopaonik.

[9] Kohn, D. & Sack, B, (2003). *Central Bank Talk: Does it Matter and Why?.* Federal Reserve System Washington. https://www.federalreserve.gov/pubs/feds/2003/200355/200355pap.pdf
[10] Luburić, R. & Fabris, N. (2018). Financial Literacy in Terms of Quality of Life. In Z. Punoševac, Jelenković, A. & I. Vesić (Eds.), *Proceedings of the VI International Conference "Quality System Condition for Successful Business And Competitiveness"* (pp. 45–52). Association for quality and standardization of Serbia.
[11] Magalong, D. T., & Chamoun, E. (2024). *Integrating ESG in Central Banks Operations.* State Treasury Republic of Finland. https://www.treasuryfinland.fi/annualreview2021/sustainability-is-catching-on-in-central-banks/
[12] Kyriakopoulou, D. (2019). *Central Banks And Climate Change. Official Monetary and Financial Institutions* Forum. https://www.omfif.org/wp-content/uploads/2020/02/ESG.pdf
[13] Bernhardsen, T. & Kloster, A. (2002). *Transparency and Predictability in Monetary Policy.* Norges Bank. https://www.norges-bank.no/globalassets/upload/publikasjoner/economic_bulletin/2002-02/transparency.pdf?v=09032017122121
[14] UNCTAD (2023). *The Least Developed Countries Report.* United Nations Conference on Trade and Development. https://unctad.org/publication/least-developed-countries-report-2023