VOICE

Germany Chooses Economic Nostalgia Over Saving the Planet

Central bankers are recognizing they have the power and responsibility to fight climate change. The Bundesbank would rather not.

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When Kristalina Georgieva had to choose a panel for her debut as managing director of the International Monetary Fund at the organization's fall meeting, the choice was easy: the panel on central banking and climate change. Climate change is the overriding preoccupation of our moment. Everyone wants to be part of the act. And central bankers, too, are rallying to the cause. In the world of monetary policy, however, this new preoccupation is cross-cut by another debate: how to react to a world of low inflation and negative interest rates. Central bankers are arguing about interest rate normalization, pumping liquidity into money markets, or even resorting to a new phase of quantitative easing (QE).

The United States occupies an eccentric position in these debates. Despite fears of a slowdown, the U.S. economy is actually ticking along at a reasonable pace. Earlier in the year, the Federal Reserve was still expected to raise rates. Its problem is that it faces open intimidation from U.S. President Donald Trump. Trump's White House also quashes any serious discussion of climate change. So Washington played host to IMF's green finance roadshow this fall, but American voices were largely silent.

In Europe, neither question can be dodged. In politics, Green parties rival right-wing populists as the most dynamic political force. In her pitch to succeed Mario Draghi as the head of the European Central Bank (ECB), Christine Lagarde made green finance one of her causes. She did so at the same moment as Draghi's last-minute decision to launch a new round of QE to stave off deflation in the eurozone unleashed the dinosaurs of European central banking, roaring their protest against his relentless interventionism.

Germany is in the crosshairs of both battles. Its politics is divided between a surging Green party and a right wing that resentfully resists the ECB, with popular newspapers portraying Draghi as Dracula, sucking the blood from Germany's savers. Meanwhile the Bundesbank, Germany's once-dominant central bank of Europe, has been eclipsed by the rise of the ECB. Germany's monetary authorities realize that the historic gamble made by France, Italy, Spain, and the rest of Southern Europe on a common European monetary policy is paying off. Whereas in the old days of the European exchange rate mechanism they struggled to hold their currencies in line with the German mark, giving the conservative German central bank the decisive voice in continental monetary policy, the pooled sovereignty of the eurozone gives them a vote. And when it comes to monetary stimulus, Germany has found itself again and again in a minority.

It is probably too late to reverse that, but the Bundesbankers are fighting back. With remarkable lack of regard for collegial solidarity, the old guard of retired German central bankers issued an open letter against the latest round of QE. Their aim appears to be not only to spoil Draghi's goodbye party but also to box in his successor. Meanwhile, Jens Weidmann, the current head of the Bundesbank and thus a member of the ECB's Governing Council, has anchored the opposition from within the pan-European bank. He opposed Draghi's promise of "whatever it takes" that saved the euro in 2012. He opposed QE in 2015. He has given evidence against the ECB in the German supreme court. And in 2019, he has once again spoken out against monetary stimulus. Now he seems determined to draw green finance into the battle, too.

Not that the Bundesbank indulges climate change denial. At an event on the climate crisis recently hosted by the Bundesbank, Weidmann started by recognizing the scale of the risk. It is now widely believed that so-called stranded assets—devalued fossil fuel investments—could be a trillion-euro problem. Weidmann acknowledges this means that bank regulators must act. But on the basics of credit policy and monetary policy, he drew a sharp line. There can be no lower risk-weighting for green assets, which would give banks an incentive to favor green lending. There can be no discrimination against carbon-intensive brown assets. And in the ECB's new QE program, there should be no favor shown to green bonds—so-called Green QE—an idea that has been widely discussed but that he attributes to an essay I published with *Foreign Policy* over the summer.

In each case, the argument is fundamentally the same. It is up to the market to set prices and assess risk. Central banks, if they have to intervene or regulate, should do so in a way that does not distort this price discovery by the market. If the central bank buys bonds, it should be guided by the risk ratings of the ratings agencies. This is the principle the ECB likes to call neutrality. To do anything else involves skewing prices, a judgment that Weidmann insists is not the prerogative of central bankers. Who benefits and who pays for decarbonization is a distributional issue. That is a matter for politicians to decide. They have democratic legitimacy. A proactive green central bank policy would be yet another exercise in high-handed technocracy.

German conservatives are fixated on the idea that Draghi is to blame for the rise of the right-wing Alternative for Germany party that now haunts German politics. Back in 2013, the party was founded to protest against the ECB's alleged leniency toward Southern Europe. (Yes, you read that right.) After doubling down on Islamophobia and xenophobia, and emerging as a major force in East Germany, Alternative for Germany is now trying to broaden its appeal by positioning itself as an anti-Green party, opposed to feminist and environmental politics.

Weidmann's suggestion is that proactive green central banking would be an invitation to populism.

This, of course, is an extraordinarily one-sided argument. In the ordinary course of monetary policy, every central bank routinely makes distributional decisions. The Bundesbank's legendary commitment to low inflation is a decision in favor of creditors over borrowers. It may be justified in terms of its long-run benefits for growth or the advantages of avoiding spikes in inflation or simply as a conservative defense of private property. But it cannot be defended as neutral.

Likewise, the Bundesbank's opposition to Draghi's quantitative easing is not merely a technical monetary policy decision. Southern Europe has an interest in greater stimulus and a desperate need to avoid deflation. By contrast, the voices speaking for German savers encourage them to believe that they would be better off in a world of higher interest rates and lower prices, regardless of the broader economic consequences. Weidmann, in his appearances in the German tabloid *Bild*, is one of the voices encouraging them in this belief. Far from being neutral, he has helped to entrench a view of eurozone monetary policy that sees it not as the effort to maintain overall economic growth but as a distributional struggle between Northern and Southern Europe.

In financial markets, too, abdicating judgment to the rating agencies has consequences. With regards to central bank bond-buying, the result is that both the Bank of England and the ECB acquired large portfolios of fossil fuel-intensive bonds. For advocates of Green QE, that is an argument for changing the rules. For Weidmann, it is an opportunity to kill two birds with one stone. If the new ECB board were to overturn Draghi's last-minute QE decision, the awkward question of whether to buy brown or green bonds would not arise. Green QE gives hostages to fortune. Weidmann conjures a nightmare scenario in which a central bank found itself having to choose between its green commitments and the need to curb inflation by turning off the monetary taps. This would trigger political controversy and put the independence of the central bank at risk.

Weidmann's is a hermetic conservatism that amounts to saying that if the ECB could only refrain from doing what is necessary to keep the eurozone economy out of deflation, then the central bankers could also avoid committing themselves to the cause of decarbonization. Both could be left to the politicians, while the Bundesbank went back to the good old days when it stood alone as the defender of price stability.

It is not just hermetic but also counterfactual. The eurozone is in its 20th year, and the Bundesbank is now firmly subordinated within it, having been repeatedly outvoted on policy since 2011. By majority vote of its other members, the ECB is now committed to a large extra dose of QE. They have acted because the threat is not Weidmann's boogeyman of resurgent inflation but the very real prospect of deflation. They have also acted because the politicians on whom Weidmann wishes to place the burden of the tough decisions are paralyzed by the tight fiscal corset that Germany insisted on back in December 2011. German conservatives may wish to rewind the clock, but Lagarde has made clear that she intends to proceed with QE. She has not ruled out Green QE, and she is holding that door open, because she acknowledges, unlike Weidmann, that on environmental policy the politicians have in fact spoken. They made their decision in Paris in 2015.

When Weidmann says that the green monetary policy lacks a democratic mandate, that central bankers must wait for politicians to decide, he speaks as though the Paris climate agreement had not happened. He speaks as though the German government had not been forced this year, by its Paris targets and mass street protests, to hold a crisis summit on climate policy. The question is not whether there is a democratic legitimation for action but whether the central banks will help.

Weidmann insists that the central bank's mandate is price stability. This is true. But once again it is one-sided. In fact, Article 127 of the treaty establishing the monetary union requires that the ECB should, "without prejudice to the objective of price stability … support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union." Among those objectives is "sustainable development." Given the total absence of inflationary pressures, not just now but for the foreseeable future, supporting Europe's governments in their pursuit of the Paris climate objectives is an entirely legitimate and appropriate ECB policy.

Where central banks can make a unique contribution to decarbonization is precisely with regard to financial markets. Those markets have the capacity to move trillions of euros into urgently needed energy investment, but only if their expectations are aligned with the path to decarbonization. The problem, as Weidmann himself acknowledges, is that they are not. Indeed, according to estimates endorsed by the Bank of England, business investment plans currently put us on a path to a catastrophic scenario of 4-degree warming. Bank regulation and stress testing can help to correct this. But given the severity of that misalignment and the speed with which the clock is ticking, it must also have broader implications for monetary policy. Whether the Bundesbank likes it or not, the eurozone is embarked on a new round of QE. The question is whether that program will support decarbonization or reinforce the unsustainable status quo. To uphold the neutrality principle is to endorse the market's catastrophic vision of the climate future.

And the force of this point is even greater when we consider why the markets hold this contrarian position. It is convenient to blame this on the shortsightedness of investors. But that is too kind. The willingness of major financial actors to invest in a 4-degree future is at least in part a calculated long-run gamble on the failure of politicians to make good on the Paris commitments. After all, given the track record of governments to date, that is only reasonable.

That is a judgement for investors to make. What is clearly unacceptable is for the ECB in the name of neutrality to be endorsing the cynicism of the markets. Given its mandate under Article 127 and the clearly expressed decision of Europe's democratically legitimated government, the ECB has the responsibility to lean on the markets to bring them into line with the glide path to decarbonization that Europe has collectively decided on. Other financial actors have no problem with this idea. The World Bank is ending lending for oil and gas. The European Investment Bank has ended coal funding and is working on its board to overcome German reluctance to ending gas finance too. In the process, they reshape market expectations and bring them into alignment with political vision.

This is what Mario Draghi did in 2012 when he demanded that the markets take seriously the eurozone's effort at state-building and committed the ECB to doing "whatever it takes" to defend the euro. That may be an uncomfortable memory for the Bundesbank, but that should not stand in the way of European institutions committing themselves to decarbonization. We have no time to lose.

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