

DE-RISKING THE ENERGY TRANSITION

WHY CENTRAL BANKS NEED TO ACT, NOT WAIT

OCTOBER 2024



Global society is currently struggling to address the climate emergency and to organize the swift energy transformation from fossil fuels to renewables that is needed in the 2020s and '30s. Despite three decades of UN climate negotiations, emissions have not decreased. The physical reality of global heating and its link to cumulative emissions (as expressed in a “carbon budget”) means that the transition must come swiftly. (See Figure 1.)

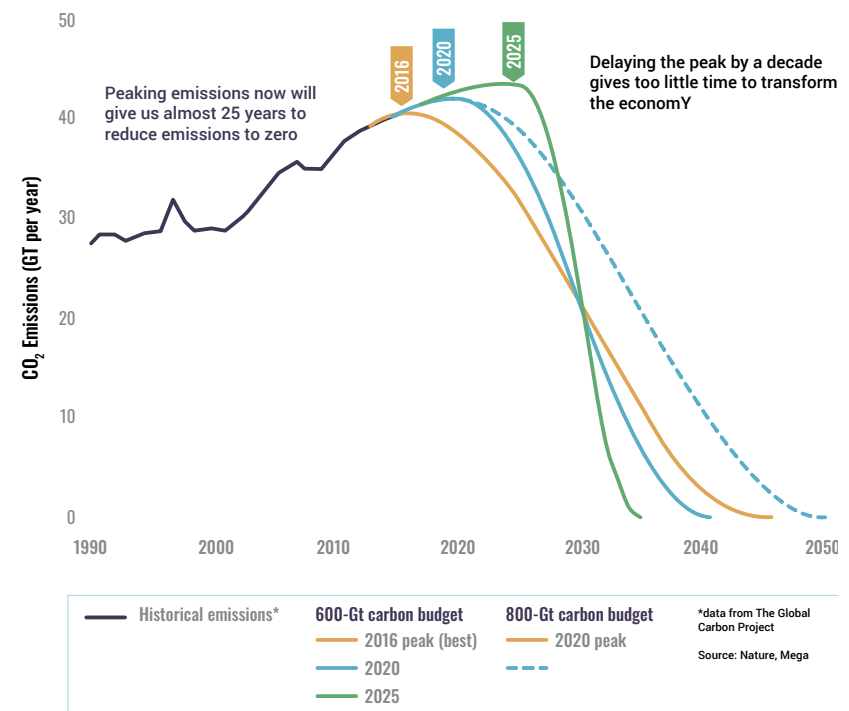


Figure 1. Carbon crunch. Source: Pictet Asset Management

Central banks have identified **two main risks** from climate change for financial stability: 1) **physical climate risk** and 2) **transition risk**. Current approaches mainly focus on managing both risks passively: for example, through disclosure rules, and marginal integration into the financial supervision framework. Additional proposals have suggested a more active approach through green quantitative easing or penalizing factors for fossil investments, but without widespread action so far. A wait-and-see approach is not appropriate for central banks in the current situation, nor is it the only option they have available.

Instead, an **active approach to de-risking the energy transition** would allow for minimizing risks to financial stability while making a decisive contribution to removing obstacles to a swift energy transition, which is essential for a thriving society – and economy.

On **physical climate risk**, so far, central banks have taken on a spectator role, rather than activating all available levers to find a path towards climate safety. Disclosing physical climate risk is, of course, an important step. Societies must now move on to the next stage: leveraging the information disclosed to find ways of minimizing physical climate risk by **stopping the burning of fossil fuels**.

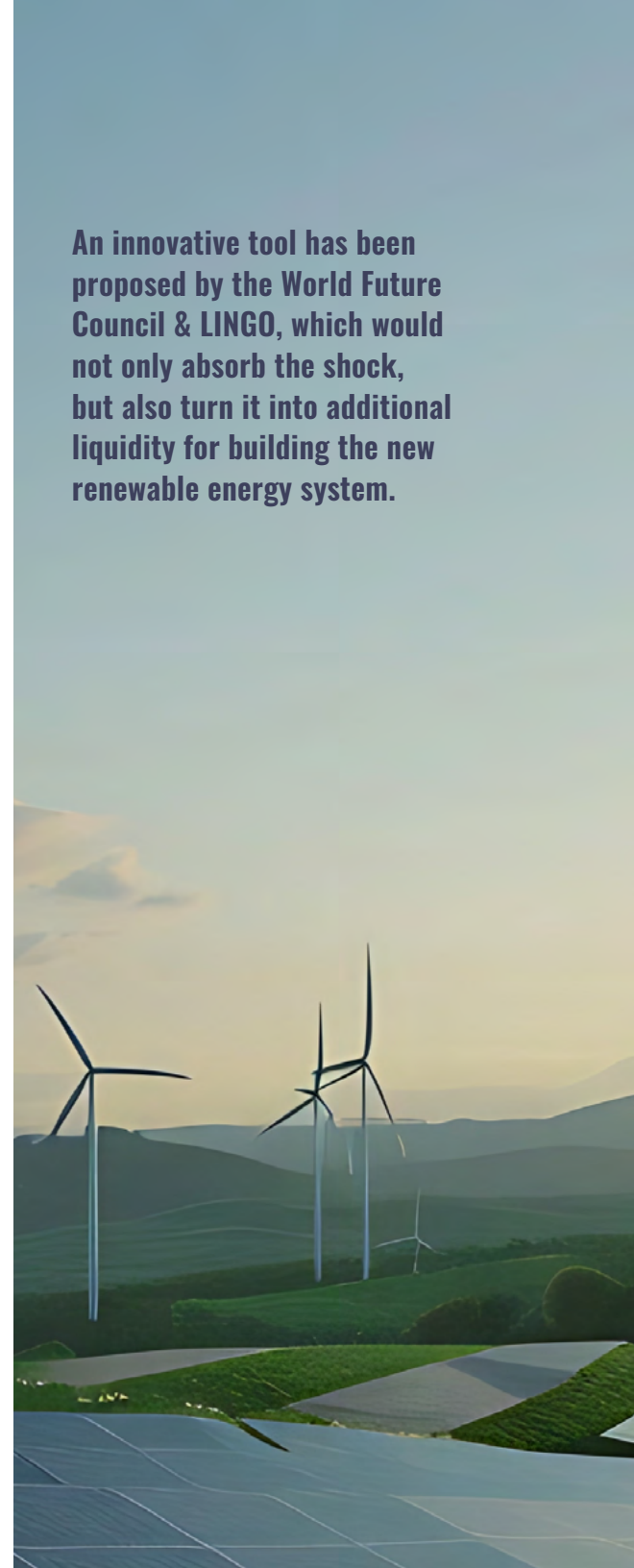
On transition risk, central banks, particularly in the Eurosystem, have begun to integrate the risk associated with the transition, both through one-off stress tests and, over the longer term, by adapting the banking supervision framework. However, transition risks are still insufficiently covered.

As of 2024, central banks seem to be in favor of continuing the status quo (called “burning down the house” by some), with major physical impacts in the future. One major danger is the realistic prospect of run-away climate change toward a “hothouse Earth.”¹ Since there is “no economy on a dead planet”, the continuation on this path of rising emissions can only be characterized as dysfunctional. A swift, yet volatile transition to renewable energies is required, implying significant transition risks in the transformation process. With each passing year, the situation becomes worse.

The proposed solution is to **actively de-risk the energy transition** through tools at the disposal of central banks. A key element of de-risking the energy transition is to manage the depreciation of fossil fuels and their associated assets by absorbing the shock. An innovative tool has been proposed by the World Future Council & LINGO, which would not only absorb the shock, but

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¹ Steffen et al. (2018), *Trajectories of the Earth System in the Anthropocene*. Proceedings of the National Academy of Sciences, vol. 115 no. 33 8252–8259.



also turn it into additional liquidity for building the new renewable energy system.² The proposal suggests enabling fossil fuel actors to sell potentially stranded assets to central banks in exchange for committing to invest the proceeds in renewable energy, supported by multilateral development banks, stabilizing energy supply and prices. A “bad bank” could absorb fossil fuel assets and manage them for a rapid wind-down. A discount to market prices that increases over time could limit the potential for moral hazard in a de-risking mechanism.

A major co-benefit of the proposed approach is to make “fossilflation” history, as renewable energy systems are not exposed to the price shocks of fossil fuel-based energy systems which are to blame for much of the recent strong increase in Euro-area inflation.³ Studies have already shown that “greenflation,” although material in the short term, is rapidly absorbed as the economic system adapts to the production of low-carbon energy and goods. In any case, a swift energy transition would reduce climate damages to society and thus also contribute to lowering physical climate risk.

Signaling a central bank involvement in shutting down fossil fuels will put all financial and industry actors on notice and may itself help to smooth the transition. A political mandate for de-risking the energy transition, as proposed here, will be useful to set the action on a more solid foundation and could be given for example by the European Parliament for the European Central Bank, or via letter from the chancellor to the Bank of England.

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- 2 Kroll & Kühne (2024), “Climate Bailout”: a new tool for central banks to limit the financial risk resulting from climate change. *Int Environ Agreements* 24, 217–232.
- 3 According to Isabel Schnabel (ECB), in February 2022, energy accounted for more than 50 percent of headline inflation in the Euro area, mainly reflecting the sharp increases in oil and gas prices.

