EU Taxonomy and ECB Monetary Policy: Moving Towards Centrally-Directed Green Capital Allocation?

Abstract: Prominent ECB representatives have stressed the goal of the ECB to green its monetary policy, inter alia by moving from market neutrality to (green) market efficiency as guiding principle of monetary policy making. The paper explores how the EU taxonomy could become the benchmark for a monetary policy of the ECB, which influences the credit allocation of commercial banks, with a negative impact on allocation efficiency and growth in the European Union.

Keywords: EU taxonomy, ECB monetary policy, green capital allocation

JEL Classification: E40, E44, E5, Q54

1 Introduction

Since the birth of the euro in January 1999 the monetary policy framework of the ECB has gone through significant changes (Schnabl and Sepp 2021). Originally, the European Central Bank (ECB) was imbedded in the Treaty of the Functioning of the European Union (TFEU) as independent central bank (§130), being primarily committed to price stability (§127) with the prohibition to finance government expenditure (§123). Meanwhile the Eurosystem has accumulated government bonds equivalent to more than 4,000 billion euros in its balance sheet, which is argued to be in contradiction to the TFEU (Stark, Mayer, and Schnabl 2020).1

The massive bond accumulations intensify debates on which principles should guide the ECB’s portfolio allocation. Up to the present this allocation has been guided

---

1 Concerning the influence of euro area governments on the ECB’s monetary policy decisions see also Heinemann and Kemper (2021).

---

I thank Nils Sonnenberg and a referee for excellent comments.

*Corresponding author: Gunther Schnabl, Institute of Economic Policy, Leipzig University, Grimmaische Straße 12, 04109 Leipzig, Germany, E-mail: schnabl@wifa.uni-leipzig.de

© 2022 the author(s), published by De Gruyter. This work is licensed under the Creative Commons Attribution 4.0 International License.
by the principle of ‘market neutrality’ that minimized – in line with principle of the TFEU of an “an open market economy with free competition, favouring an efficient allocation of resources” – any impact of its operations on the market structure. Yet, ECB board member Schnabel (2021) has signaled a shift from ‘market neutrality’ to ‘market efficiency’ to “avoid mispricing of risk associated with climate change”. The ECB’s climate stress test among large euro area banks (ECB 2022a) and the gradual decarbonization of the ECB’s corporate bond holdings (ECB 2022a) can be seen as first steps of greening the ECB’s monetary policy aligned with the goals of the Paris Agreement. Here the possible implementation and the impact on resource allocation and growth in the European Union are explored.

2 Capital Allocation Under the Principle of Market Efficiency

The ECB statements on market efficiency mark an important milestone away from the traditional model of capital allocation, which was based on household savings, particularly at small- and medium-sized commercial banks. The commercial banks used the savings to finance the investments of corporations based on a comprehensive assessment of the expected returns at risk-adjusted loan conditions. With a positive credit interest rate of – say – four percent only investment projects with an expected return of above this threshold were to be financed. To resolve information asymmetries small and medium banks have been maintaining stable long-term relationships with the small and medium enterprises in their regions (Berger und Udell 2006).

This capital allocation model promoted growth and welfare, as high productivity gains were encouraged, with all sectors of the economy profiting. If, for instance, the average return of the financed investment projects was six percent and corporations paid four percent interest to the banks, the banks could set aside money for the default risk and finance its non-interest costs. The banks could then pay a positive deposit rate to the depositors. If the banks financed investment by new credit and thereby creating new deposits, the newly issued money was backed by high-return investment projects. This ensured a stable money.

The task of the central bank in a two-tiered banking system (consisting of private commercial banks and a central bank) was to set the key interest rate not too low, as this would encourage the commercial banks to finance investment projects with low

2 As represented by the bank names such as Sparkasse, savings bank, caisse d'épargne, cassa di risparmio or caja de ahorros.
expected returns and thereby a higher probability of default.3 Given the principle of market neutrality the central bank would not influence the allocation of credit of commercial banks in favor of specific sectors of the economy, with commercial banks merely striving to finance the investment projects with the highest expected returns. The task of protecting the environment was left to the government, which would impose regulations or market-based instruments (green tax or tradable pollution permits) on polluting activities. The outcome was high productivity gains, high growth and gradually rising real wages. The resulting expansion of the welfare came along with the protection of the environment.

3 The Shift Towards an ECB-Guided Capital Allocation

The ECB has announced to green its monetary policy (Lagarde 2022) and to exert a stronger influence on the capital allocation in the euro area (Schnabel 2021). According to Schnabel (2022), if the market misprices the risks associated with climate change, adhering to the market neutrality principle may instead support a market structure that hampers an efficient allocation of resources.4 This also implies that the task to internalize negative environmental externalities are not only internalized by the government through the price mechanism (e.g. by a green tax or tradable pollution permits) any more, but would be partially shifted into the responsibility of the central bank.

The move towards green monetary policy became embedded into the unconventional monetary policy following the European financial and debt crisis (2008–2012), as the ECB has been keeping the main refinancing rate at zero until mid 2022. Persistent zero interest rates run the risk to undermine the capital allocation function of the interest rate, which separates between high-und low-return investment (Schnabl 2019).5 In addition, the ECB has created unconventional monetary policy tools such as outright purchases of government, corporate and

3 On the role of too low interest rates on the quantity and quality of investment and thereby the likelihood of crisis see Hayek (1929). Given too low interest rates, the newly created money would be backed to a lesser extent by high-return investment projects, which would undermine to credibility of the money.
4 Schnabel (2022) sees the following links between climate change and price stability as the primary target of the ECB: As the number of natural disasters and severe weather events is rising, prices rise as well (“climateflation”). The sharp rise of oil and gas prices (“fossilflation”) reflects the legacy cost of the dependency on fossil energy resources. The transformation to low-emission technologies leads to price increases (“greenflation”).
5 See also Leibenstein (1966) on X-inefficiency and Kornai (1986) on soft budget constraints.
covered bonds as well the provision of long-term credit lines for banks to stimulate the economic activity. These tools have not only extended the volume of credit to the governments, households, and enterprises, but have also opened the possibility to influence the structure of the funding in favor of specific sectors.\(^6\)

With the so-called Targeted Longer-term Refinancing Operations (TLTROs), initiated in 2014, the ECB influences the credit provision of commercial banks (Schnabl and Sonnenberg 2020). The TLTRO programs offer longer-term funding at preferential interest rates, if commercial banks subsequently hand out credit provided by the ECB to households and enterprises.\(^7\) In the TLTRO-III program launched in 2021 banks could access credit at an interest rate as low as \(-1\%\) (deposit facility rate of \(-0.5\%\) minus 50 basis points), if the ECB’s lending performance criterion was met.\(^8\) The interest rate of the TLTRO credit paid to commercial banks between \(-0.5\%\) up to \(-1\%\) implied an outright reward, if commercial banks complied with the guidelines given by the ECB. The TLTRO credits have reached a volume of about 2200 billion euros (Oct. 2022). Meanwhile the interest rate was adjusted to minimize profits of banks and TLTRO credit has started to be repaid.

4 EU Taxonomy and the Vision of Green TLTROs

The EU taxonomy is a classification system, which establishes a list of environmentally sustainable economic activities (European Union 2020). It shall play an important role to scale up sustainable investment and to implement the European Green Deal (European Commission 2022a). Investors and policymakers are guided with definitions which economic activities can be considered environmentally sustainable. It establishes six environmental objectives (European Commission 2022b): climate change mitigation, climate change adaptation, the sustainable use and protection of water and marine resources, the transition to a circular economy, pollution prevention and control as well as the protection and restoration of biodiversity and ecosystems. Large financial and non-financial corporations are subject to mandatory requirements on disclosure, with the aim of providing transparency on the environmental performance.

\(^6\) Note, that if governments can extend their expenditure due to government bond purchases of the central bank, they can influence the economic structure or subsidize specific enterprises via the expenditure pattern.

\(^7\) In addition, the TLTRO credit allowed banks to extend their scale of credit provision. Banks that have few reserves need minimum reserves for additional lending and deposit creation. If they could not borrow them via the interbank market, TLTRO credit allowed to receive the reserves directly from the ECB, which has been the case since the financial crisis under the full allotment system.

The TLTRO design can be seen as a blueprint for a green capital allocation in the European Union along the guidelines of the EU taxonomy. van t’Klooster and van Tilburg (2020: 4) argue that “within its current mandate the ECB can and should do more to accommodate a green and social recovery” and propose “Green TLTROs”: 9 “The key input into the design of the Green TLTRO programme is the European Commission’s EU Green Taxonomy Regulation” (van t’Klooster and van Tilburg 2020: 15). The report of van t’Klooster and van Tilburg (2020) has been created in cooperation with central bank representatives. 10 ECB board member Schnabel (2022) takes explicitly reference to van t’Klooster and van Tilburg (2020: 4) in her plea for greening the ECB’s monetary policy (albeit mentioning concerns as long as banks are missing respective classification systems 11).

According to van t’Klooster and van Tilburg (2020: 11, 12) – guided by the ECB – “commercial banks shall incentivize a specific allocation of capital towards green investment”, as “the absence of adequate private-sector green investment leads to an allocation of capital that hinders long-term price stability.” Green TLTROs could take the form of collateralized loans or repo transactions. 12 Banks continue to borrow at the regular LTRO rate from the ECB, while the Green TLTRO program provides banks with a discount on their overall volume of interest payments to the central bank. The discounted interest rate on Green TLTRO credit shall be determined by the volume of lending of a bank that complies with the EU's Green Taxonomy.

Thus, while private commercial banks shall be still free to find profitable investments and to determine the cost of credit for the customers, Green TLTROs shall provide commercial banks with cheap funding, if they properly document compliance of the EU taxonomy. 13 The ECB shall verify the taxonomy-compliance documented by banks. Concerns that some national central banks may water down the standards for compliance with the taxonomy to stimulate low-interest lending to

9 They list three justifications: (1) Green TLTROs will contribute to achieving the ECB’s primary mandate by addressing market failures that undermine the broader economic preconditions of monetary stability. (2) Green TLTROs will support the ECB’s efforts to reduce environmental and climate-related financial risk built up in banks' balance sheets and thereby contribute to financial stability. (3) Green TLTROs will help to align monetary policy with the ECB’s secondary mandate, which requires it to support the EU’s environmental objectives where this is possible without prejudice to price stability.

10 The authors thank four anonymous central bankers for comments.

11 “Many banks, for example, do not yet effectively differentiate between green loans and other loans, making a green TLTRO difficult on a practical level” (Schnabel 2022).

12 This centralized system of credit allocation could be flanked by an assessment of other credits of commercial banks based on climate risks. The ECB has recently engaged in a respective climate stress test (ECB 2022b).

13 See van t’Klooster and van Tilburg (2020: 17) on the respective reporting requirements on banks.
their countries\textsuperscript{14} may be addressed by fixed quotas for Green TLTRO funding for the euro area member states (van t’Klooster and van Tilburg 2020: 20).

5 Implications for Welfare and Political Stability

Given that Green TLTROs will be implemented linked to the taxonomy of the European Union, further fundamental changes in the ECB’s monetary policy making would be the consequence. High interest rates for investments in non-green sectors combined with low interest rates for investment in green sectors would shift the structure of the economy towards sectors classified as green by the EU taxonomy.

With ‘market neutrality’ being substituted by ‘market efficiency’ both the monetary policy of the ECB and the credit allocation of commercial banks would be guided by the taxonomy of the European Commission. The upshot is that the independence of the European Central Bank as enshrined in §130 TFEU would be undermined. The low interest rate provision on green TLTROs could constrain the ECB in raising interest rates to contain inflation, as low interest rates provided to some sectors of the economy could lead to pressure by other sectors on the ECB to constrain the tightening of their financing conditions.

Hayeks (1945) knowledge problem accrues, as bureaucrats interfere with the free credit allocation of commercial banks. Despite extensive reporting requirements, the European Commission and the ECB may not be able to fully anticipate short-term and long effects of Taxonomy compliant investment on climate and environment. Given possible lobbyism and an unresolved knowledge problem, the risk of a misallocation of funds and thereby an extensive waste of resources is high.

This must result in a higher misallocation of funds in comparison to a system where scarce resources are allocated to projects under the condition of profitability (with possibly negative external effects being internalized by green taxes or emission trading). If the EU implements at the same time market-based solutions to internalize environmental externalities (most prominently through the EU Emissions Trading System) an additional surcharge on carbon-intensive investments will lead to double-pricing and will, therefore, not be efficient.

The expected average return of investment in the European Union can therefore be expected to further decline, eventually becoming negative. This implies that the average real income in the European Union has to decline, which will amplify distribution conflicts that have been already caused by the ECB via asset and consumer price inflation. The upshot is, that growing political instability could threaten social cohesion and thereby also the attempts to green the EU economy.

\textsuperscript{14} Which could lead to different money market interest levels in different parts of the euro area.
References


European Central Bank. 2022a. ECB Provides Details on How it Aims to Decarbonise its Corporate Bond Holdings (accessed November 19, 2022).


European Commission. 2022b. EU Taxonomy for Sustainable Activities. What the EU is Doing to Create an EU-wide Classification System for Sustainable Activities (accessed October 24, 2022).


