

Towards a Green monetary Policy for Developing Countries: A Climate Rating Mechanism for Funding Sustainable Projects

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(i) Motivations underlying the research

The article falls within the framework of the pressing issue of global warming and its potential economic and social consequences knowing that climate change poses significant risks to economies, financial stability, and the well-being of societies worldwide. Therefore, there is a need for massive and decisive action to be taken by central banks with a view to greening its monetary policy. While developed countries have taken some steps towards green monetary policies, the authors argue that developing countries need specific financing solutions to support their climate projects.

The aim of this research is to propose a mechanism that allows developing countries to integrate climate considerations into their monetary policies, particularly through local development banks. By doing so, these countries can support sustainable projects, contribute to the 2°C objective set by the Paris Agreement, and secure a green future for their economies.

(ii) A short account of the research performed

The research proposes a mechanism for the greening of monetary policy in developing countries, with a focus on supporting local authorities engaged in pro-environmental projects. The mechanism involves a climate-rating model, which assesses the environmental and social risks of various investment projects seeking funding from local development banks. Central banks play a crucial role by providing liquidity to local development banks, contingent on their financing of low-carbon projects. The central bank can play a key role in financing green projects by providing liquidity to local development banks specifically channelled, as a collateralized loan, to “local authorities” that undertake environmentally friendly actions.

The climate rating model evaluates the creditworthiness of local authorities and the environmental parameters of the projects. It categorizes projects into four risk levels: A, B, C, or D, with D representing projects with the highest environmental and social risks and being systematically rejected. The local development bank's counterparty risk is determined by a combination of both the municipality's and the project's rating, ensuring that only green projects with appropriate ratings receive funding. The proposed mechanism aims to foster green financing by local development banks, incentivizes the development of the green securities markets, and ultimately green the central bank's balance sheet.

A concrete case study has been presented showing how our suggested mechanism is contributing to the greening of the monetary policy by funding sustainable projects through a local development bank. By integrating climate considerations into their monetary policy, developing countries can enhance the sustainability and profitability of green projects and contribute to the global fight against climate change.

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(iii) The main conclusions and policy implications of the work

The research concludes that a pro-climate monetary policy is essential for developing countries to combat climate change effectively. Central banks can encourage local development banks to fund sustainable projects, by incorporating climate ratings into the financing decision-making process. The proposed mechanism promotes a societal shift, recognizing the environment's central role in the economy, and fostering urgency in achieving the 2°C objective.

Overall, the proposed mechanism provides a path for developing countries to navigate the challenges of climate change while maintaining financial stability and economic growth.

As policy implications, the adoption of this mechanism by central banks of developing countries can stimulate the generalization of climate rating, leading to increased investments in low-carbon projects. Furthermore, it will strengthen the development of the green finance market, enabling the alignment of financial strategies with climate objectives. The authors advocate for a paradigm shift which entails a seamless integration of climate considerations into monetary policy guiding investment decisions, and, in turn, fostering a holistic framework for sustainable economic development.

By embracing green monetary policies, developing countries can contribute meaningfully to the global effort to combat climate change and ensure a sustainable future for generations to come.