The Daily Dish

Climate Change and Financial Stability

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Eakinomics: Climate Change and Financial Stability

This past Wednesday the Commodity Futures Trading Commission (CFTC) released a report it had commissioned on climate change and the U.S. financial system. The CFTC had voted unanimously (which means on a bipartisan basis) to create a Climate-Related Market Risk Subcommittee and task it with a report covering evaluation and management of climate-related risks to the financial sector, the effective use of climate stress tests, and policy recommendations.

The CFTC did not vote to approve the report or endorse its recommendations (and there were 53 concrete recommendations), but that is not the important point. The most important point is that the CFTC chose to investigate the implications of climate change, which means that it acknowledged the existence and potential importance of climate change. This represents another important step in reaching a bipartisan consensus on the scale, scope, and timing of the climate change problem, as well as appropriate policies to address the issue.

AAF's Ewelina Czapla and Thomas Wade reviewed the report and concluded, "the key finding is that 'climate change could pose systemic risks to the U.S. financial system.' Even a conclusion that climate change could pose *any* risk to the financial system would be dramatic enough, particularly from this administration. That the report elevates this potential risk to 'systemic,' or having the capacity to collapse an entire industry or the economy, is a startling indication of the seriousness of the perceived threat."

In terms of key insights into the analysis, there are two main points. The first is that the United States (and, indeed, the globe) needs to address the problem. The preferred route is to put an economy-wide price on carbon (e.g., a carbon tax) that is in line with the damage the emissions are doing. Obviously, this has been an enormous political challenge in the United States and abroad.

Second, there is a huge gap in data on the scale of the problem, much of which is unknown and unquantified. The report calls for developing additional data on the impact of environmental changes on market participants, instruments, and functioning. The combination of these two issues means that climate-induced risks will not be appropriately priced into financial transactions, their manifestation will cause dramatic financial fluctuations, and the stability of the system will be at risk.

That is a troubling conclusion because the United States will "solve" the climate problem only as fast as American business is given incentives to do so, and this indicates that those incentives will not be priced into financial markets. The conclusion is much deeper than just the financial sector.

To me, at least, there is a third point that should have been mentioned in the report. Financial markets will continue to evolve even as climate change occurs – and perhaps even offer new products as a result. That means the goal should not be to understand how to prevent instability of the *future* financial system, which would

require continuous updating of the nature of the risk exposures.

The CFTC report is not the final word on anything. But it is an important sign of recognition that the potential risks to financial markets posed by climate change represent a pervasive policy challenge.