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THE NET ZERO CHALLENGE

RBI report provides a framework to discuss trade-offs during the transition

ALICE RIVLIN, VICE chair of the Federal Reserve Board in the 1990s, aptly remarked that the “job of a central bank is to worry”. The RBI’s Currency and Finance Report for 2022-23 — “Towards a greener cleaner India” — is proof that the central bank is on the job. It is a timely update to its previous reports that had left many wondering what will be its response to climate change. The report covers an expansive set of issues, and conveys the central bank’s future course of action.

India is committed to achieving net zero status by 2070 at CoP26. The road to net zero will not be smooth, as is reflected in the report. The RBI provides a much-desired framework of thinking about the trade-offs between growth, inflation and efforts to transition to a net zero economy. There is a tension between India’s ambition to achieve advanced economy status by 2047 and lowering its emissions. An annual GDP growth rate of 9.6 per cent would raise net GHG emissions by 10.5 times of levels in 2021-22. In a scenario where India seeks to achieve dual objectives of net zero by 2070 and advanced economy status, it would have to increase the share of green energy in primary energy consumption to 82 per cent by 2070 and reduce emission intensity by 5.4 per cent annually. The report’s finding that nationally determined contribution will set back economic output by as much as 9 per cent by 2049 is a wake-up call. Only a more ambitious action of achieving net zero by 2050 would

limit the losses from extreme weather events and decarbonisation to 3 per cent by 2049. The question for policy is how can India scale its ambition given the constraints set by investment costs.

The report also weighs on the inflationary impact of the status quo against the alternative of achieving net zero by 2050. The latter will raise prices over the next three years but will subdue persistent inflationary effects over the long term. The empirics, therefore, make it clear that transitioning to net zero by 2050 may be a better option globally.

Once the shift is set in motion, the productive life of existing fossil fuel-based assets will be shortened thus exposing the banking sector (through loans) to these assets. Such risks are more pronounced for public-sector banks. However, the financial risks are not just limited to conventional energy, non-conventional energy registered an increase in share of industry bad loans. With an annual estimated investment cost of 5-6 per cent of GDP, associated risks to the financial system are also anticipated by the report. At the same time, there are risks to assets, and therefore to the banking system, from the growing incidence of extreme weather events. RBI’s assessment is that a one-period climate shock can reduce output by 1 per cent up to five quarters. This in turn will reduce incomes and consumption.

The important question then is what

are the policy alternatives to address these risks. Interestingly, the report lays significant emphasis on the role of fiscal policy. It makes a case for fiscal intervention in the form of a carbon tax or an emission trading system. It finds that a carbon tax of \$25 per tonne and \$50 per tonne of Co2 under different scenarios can be effective, alongside other policy interventions.

The importance of a carbon tax is indisputable, especially given the G7’s commitment to trade based tax measures. However, its distributional consequences are not addressed at all. It remains unclear from the analysis the level of carbon tax most compatible with different growth outcomes. It is also unclear which tax redistribution mechanisms can mitigate the distributional consequences.

The report sets the tone for monetary policy in the coming years. But it also lays out policy questions that remain widely unaddressed — the need for a taxonomy and sectoral pathways aligned with net zero. While it does mention the role of shifts in production to less energy intensive sectors — fisheries, textiles, land transport and services — there is no roadmap for these sectors that have long confronted legacy issues. As the RBI takes on the responsibility of managing risks, fiscal policy and regulatory measures are also needed to meet the challenges.

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