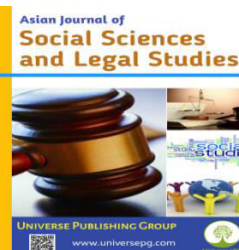




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Climate Change and Green Monetary Policy: Is Bangladesh Ready for a Sustainable Central Banking Model

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Abstract

Climate change constitutes an existential and multifaceted threat to the macroeconomic and financial stability of climate-vulnerable emerging economies. For Bangladesh, this reality necessitates a fundamental re-evaluation of its central banking functions. This paper critically assesses the readiness of Bangladesh Bank (BB) to transition from its current, pioneering green banking framework towards a fully integrated and strategic sustainable central banking model. While BB has been a regional leader - establishing a mandatory Sustainable Finance Policy with direct green finance quotas and detailed reporting requirements - we contend that this compliance-based, credit-direction approach is fundamentally insufficient for diagnosing and managing the systemic nature of climate-related financial risk. Through a rigorous, mixed-methods methodology involving critical policy document analysis, review of BB's financial performance data, and comparative case studies of frontrunner institutions like the European Central Bank and the People's Bank of China, this study identifies a critical governance gap. Our findings demonstrate that BB's framework lacks the advanced, proactive tools - such as climate stress testing to quantify portfolio vulnerability, a green collateral framework to incentivize sustainable assets, and differentiated reserve requirements that are essential for a resilient financial system. This gap between directing credit and internalizing risk leaves Bangladesh's economy exposed. Consequently, we argue the country is at a pivotal juncture. It possesses the foundational policies but must urgently embrace a strategic, risk-based paradigm to properly safeguard financial stability and channel capital at the scale and speed required by its ambitious Climate Prosperity Plan. The paper concludes by proposing a novel, phased three-horizon roadmap to guide this transition, emphasizing initial capacity building, subsequent market incentivization, and ultimate deep structural alignment to secure a prosperous and climate-resilient economic future for Bangladesh.

Keywords: Green monetary policy, Climate risk, Bangladesh bank, Sustainable finance, and Central banking.

1. Introduction

Bangladesh stands on the front lines of the climate crisis. As a densely populated, low-lying deltaic nation, it faces an escalating barrage of climate-related

shocks, from intensifying cyclones and riverine flooding to salinity intrusion and sea-level rise. The economic costs are staggering; the World Bank estimates that climate change could depress Bangla-

desh's GDP by as much as 9% by mid-century under a high-emissions scenario (World Bank, 2022). This environmental vulnerability translates directly into financial vulnerability. Physical risks-damage to assets and disruptions to supply chains-and transition risks-stranded assets and revaluations due to climate policy-threaten the stability of the very financial system that underpins the nation's remarkable economic growth (Latif, 2025).

In this context, the role of the central bank, Bangladesh Bank (BB), is undergoing a necessary and radical re-evaluation. Traditionally, the mandates of central banks have been narrowly defined around price stability, financial system stability, and, in some cases, full employment. The climate crisis, however, fundamentally imperils all these objectives. It acts as a "threat multiplier" for inflation (through supply shocks in agriculture and energy), a source of systemic financial risk (through devalued collateral and increased defaults), and a drag on employment and productivity (NGFS, 2019). This recognition has given rise to the concept of "green monetary policy"-the use of central banking tools to mitigate climate-related financial risks and support the transition to a sustainable economy.

Bangladesh Bank has not been a passive observer. It emerged as a global pioneer among emerging market central banks by introducing formal Green Banking Guidelines in 2011, later evolving into a comprehensive Sustainable Finance Policy. These directives have successfully mobilized a growing stream of credit towards environmentally friendly projects. Yet, a critical question remains: Is this pioneering framework sufficient? Does it represent a genuine integration of climate risk into the core of monetary and financial stability functions, or is it a more peripheral, directive-based approach?

This paper argues that while Bangladesh Bank has laid an indispensable foundation, it stands at a critical juncture. To truly future-proof its financial system and align with the best practices outlined by the Network for Greening the Financial System (NGFS), it must evolve from a compliance-oriented green banking model towards a risk-based sustainable central banking paradigm. This entails moving beyond di-

recting credit to actively diagnosing, pricing, and managing climate risk across the entire financial spectrum.

The paper is structured as follows. Section 2 reviews the theoretical evolution of the central banking mandate in the age of climate change. Section 3 explains the methodology of the study with detailed subsections on policy analysis, data review, and case studies. Section 4 provides a critical appraisal of Bangladesh's existing green finance architecture, highlighting its achievements and, more importantly, its limitations. Section 5 benchmarks BB's approach against the advanced tools deployed by central banks like the European Central Bank (ECB) and the People's Bank of China (PBoC). Section 6 presents a forward-looking, three-phased roadmap for BB's transition to a fully integrated sustainable central banking model. Section 7 concludes with policy implications and a call for strategic action.

2. Literature Review

The Expanding Mandate of Central Banks

The theoretical underpinnings of central banking are being fundamentally reshaped by the climate crisis. The literature has evolved from viewing climate change as a purely environmental or ethical concern to recognizing it as a core source of macroeconomic and financial risk.

From Market Failure to Macroeconomic Threat

Early literature on green finance focused on correcting market failures, such as negative environmental externalities, through fiscal policy and regulation (Pigou, 1920). The role of finance was seen as secondary. This view has been upended. The work of the NGFS, a coalition of over 130 central banks and supervisors, has been pivotal in reframing climate change as a "source of financial risk" (NGFS, 2019). The Bank for International Settlements (BIS) advanced this further with the concept of the "Green Swan" (Boltanski *et al.*, 2020). Unlike a "Black Swan," a Green Swan event is not only highly disruptive and hard to predict but also *certain* to occur, with deeply non-linear and irreversible consequences. This characterization places climate risk squarely within the purview of central banks' financial stability mandates.

The Dual-Mandate Dilemma and the "Market Neutrality" Myth

A central debate in the literature concerns the potential mission creep for central banks. Critics argue that actively supporting green objectives oversteps their mandate and could lead to allocative inefficiencies and fiscal dominance (Schnabel, 2022; Ogou *et al.*, 2025). Proponents, however, contend that this is a false dichotomy. When climate risks threaten price and financial stability, addressing them is not mission creep but mission-critical (Elderson, 2021).

A key pillar of this debate is the principle of "market neutrality," which has traditionally guided central bank asset purchases (e.g., Quantitative Easing). This principle holds that a central bank should purchase assets in proportion to the outstanding market volume, without distorting relative asset prices. However, a growing body of literature argues that this approach is inherently flawed in the context of climate risk. By passively holding a portfolio tilted towards carbon-intensive sectors, which are disproportionately represented in major indices, central banks are effectively underpricing transition risk and exposing their balance sheets to potential losses (Boneva *et al.*, 2021). This has led to calls for "tilting" or "green QE," where central banks actively overweight green assets and underweight brown ones to both de-risk their portfolios and incentivize the low-carbon transition.

The Evolving Green Monetary Policy Toolkit

The literature identifies a spectrum of tools available to central banks, which can be categorized into two broad strands:

- 1) **Risk Management Tools:** This aim to identify, measure, and mitigate climate-related financial risks within the system.
 - Climate Stress Testing: Supervisory exercises to assess the resilience of financial institutions to different climate scenarios (NGFS, 2020). This is becoming a cornerstone of modern financial supervision.
 - Enhanced Disclosure: Mandating financial institutions to disclose their climate-related risks, aligned with frameworks like the Task Force on Climate-related Financial Disclosures (TCFD) or the Inter-

national Sustainability Standards Board (ISSB).

- 2) **Asset Allocation & Incentive Tools:** This aim to actively steer capital flows towards sustainable investments.
 - Green Supporting Factor/Brown Penalizing Factor: Adjusting capital reserve requirements (e.g., lower risk-weights for green assets, higher for brown ones). This is controversial due to concerns about undermining Basel accords but is under active discussion.
 - Collateral Frameworks: Accepting green bonds as collateral for central bank lending operations, sometimes with preferential haircuts (as practiced by the PBoC).
 - Refinancing Operations: Providing cheap, long-term funding to banks specifically for on-lending to green projects (a model used by the Bank of Japan and the ECB).

The scholarly consensus is coalescing around the necessity for central banks, particularly in vulnerable economies, to proactively deploy a suite of these tools. This presents a core theoretical tension: the conflict between the traditional, market-based paradigm of modern central banking and more interventionist approaches. The "market neutrality" of QE is one facet; another is the historical practice of credit guidance (or "window guidance"), where central banks direct credit to specific priority sectors, a tool famously used in post-war Japan and South Korea. Bangladesh Bank's current "targets and quotas" model can be understood as a modern, ESG-inflected form of credit guidance. The critical scholarly debate, which this paper engages with, is whether such directive models are sufficient, or if they must be superseded by a more sophisticated, market-based risk-pricing paradigm that uses the tools outlined above to "get the prices right" and allow the market to autonomously reallocate capital.

3. Methodology

This study employs a mixed-methods approach to critically appraise Bangladesh Bank's readiness for a sustainable central banking model, combining qua-

litative policy analysis with quantitative data review and structured comparative case studies.

Critical Policy Document Analysis

The primary documents of Bangladesh Bank's sustainable finance framework-including the *Green Banking Guidelines* (2011) and successive iterations of the *Sustainable Finance Policy* (up to 2024)-was subjected to a qualitative content analysis. The analytical framework was designed to identify the underlying regulatory philosophy. The coding criteria focused on:

- Prescription vs. Principle: The prevalence of specific, quantitative targets (e.g., 5% direct green finance quota) versus principles-based, risk-management requirements.
- Focus on Output vs. Outcome: Whether policy mechanisms prioritize measurable loan *volumes* or the assessment and pricing of climate-related financial *risks*.

- Instrumentation: The types of tools deployed (supervisory directives vs. monetary policy incentives).

This analysis directly informed the identification of the framework as "compliance-based" and revealed the gap between credit direction and systemic risk internalization.

Review of Financial and Performance Data

To assess the outcomes of BB's policy framework, we analyzed time-series data from BB's own publications. The primary datasets were:

- Bangladesh Bank Quarterly Reviews of Green Banking Activities (2020-2023): Tracking the growth in total direct green finance.
- Bangladesh Bank Annual Reports: For contextual data on total bank credit and GDP growth.

Table 1: Key Performance Indicators of BB's Sustainable Finance Policy (2020-2023).

Year	Total Direct Green Finance (BDT Crore)	YoY (year-over-year) Growth	As % of Total Bank Credit
2020	25,150	--	~1.8%
2021	31,458	25.1%	~2.0%
2022	38,715	23.1%	~2.2%
2023	44,268	14.3%	~2.4%

Source: Compiled from Bangladesh Bank (2023) Quarterly Reviews.

While this data demonstrates commendable credit mobilization (output), its limitations for risk assessment (outcome) are clear, underscoring the need for the different data proposed in the roadmap.

Structured Comparative Case Study Analysis

The selection of the People's Bank of China (PBoC) and the European Central Bank (ECB) was deliberate to provide contrasting yet complementary models from

both a developed and a major emerging economy. The analysis was structured using a common framework to evaluate each central bank on:

- Primary Objective: Risk management vs. strategic incentivization.
- Key Tools Deployed.
- Applicability to Bangladesh's Context.

Table 2: Comparative Analysis of Frontrunner Central Banks.

Aspect	People's Bank of China (PBoC)	European Central Bank (ECB)	Applicability to Bangladesh
Primary Approach	Strategic Credit Guidance & Incentivization	Risk-Based Supervision & Market Correction	Blend: Needs incentives (like PBoC) but must be grounded in risk data (like ECB).
Exemplar Tools	Carbon Reduction Support Facility (CRSF) Green Finance in MPA Green Bond Collateral	Economy-wide Climate Stress Test Tilting Corporate Bond Portfolio Enhanced Disclosure & Capital Add-ons	CRSF model is highly replicable. Stress testing is an urgent priority.

			Tilting is a long-term goal.
Key Lesson	Power of embedding green performance into core monetary and prudential incentives.	Primacy of data-driven risk assessment to force the financial system to internalize climate risks.	Synthesis required: BB must build the ECB's risk management foundation to deploy the PBoC's incentives effectively.

Political Economy and Implementation Constraints

A critical appraisal of Bangladesh's readiness must extend beyond technical policy design to consider the political and institutional landscape. The transition proposed faces several potential headwinds:

- **Resistance from Incumbents:** Powerful industrial groups with significant investments in "brown" sectors (e.g., textiles, fossil-fuel-based power, and leather) may lobby against policies that increase their cost of capital or restrict credit access.
- **Technical Capacity Gap:** Conducting climate stress tests and managing a green collateral framework requires sophisticated modeling expertise and data systems that are currently underdeveloped within BB and the financial sector.
- **Cross-Ministerial Coordination:** Effective implementation requires close collaboration with the Ministry of Finance (on fiscal policy and sovereign green bonds), the Ministry of Environment (on national climate targets), and the Ministry of Power (on energy transition), which can be challenging to orchestrate.
- **Legal Mandate Formalization:** The suggestion to amend the Bangladesh Bank Order, while ideal for cementing the mandate, is a significant political undertaking. A more incremental pathway could involve leveraging the *existing* financial stability mandate, which already provides a legal basis for managing climate risk as a systemic threat, as argued by the NGFS. A formal mandate could be a goal of Phase 3, pursued after demonstrating success in Phases 1 and 2.

Bangladesh’s Current Stance: A Critical Appraisal

Bangladesh Bank's journey in green finance is commendable and offers a rich case study for other developing nations. However, a critical analysis reveals a system that, while advanced in rule-setting,

remains nascent in its integration of core risk-management principles.

The Pioneering Framework: Policies and Outcomes

BB's intervention began in 2011 with the *Green Banking Guidelines*, making it one of the first central banks in the world to issue such a directive. This was consolidated and expanded into the *Sustainable Finance Policy (SFP) for Banks and Financial Institutions*, regularly updated, with the latest version effective from January 2024.

The SFP is a comprehensive document that mandates:

- **Direct Green Finance Targets:** Banks must allocate a minimum of 5% of their total loan disbursement towards direct green finance, such as renewable energy, energy efficiency, and waste management.
- **Sustainable Finance Units:** Each bank must establish a dedicated unit with trained staff.
- **Environmental & Social Risk Management (ESRM):** Banks must integrate ESRM into their credit risk assessment for all loans.
- **Reporting and Disclosure:** Strict quarterly reporting on 50+ green product categories to BB.

The outcomes, in terms of credit mobilization, are significant. As per BB's Quarterly Review, total direct green finance stood at BDT 44,268 crore (approx. USD 4 billion) in 2023, showing consistent year-on-year growth (Bangladesh Bank, 2023). This capital has funded solar home systems, efficient irrigation, and green factories, contributing tangibly to national climate goals.

Identifying the Gaps: A Compliance-Based, Not Risk-Based, Model

Despite these achievements, a closer examination reveals critical gaps that prevent the current model from being considered a fully-fledged green monetary policy.

- The "Targets and Quotas" Paradigm: The core of BB's approach is a command-and-control style quota system. While effective for jump-starting a market, it focuses on *output* (the volume of green loans) rather than *outcome* (the effective pricing and management of climate risk). Banks often treat this as a compliance checkbox rather than a strategic imperative. There is little evidence that the ESRM integration has led to a material repricing of brown assets or a fundamental shift in risk assessment culture.
- Absence of Systemic Risk Assessment: The most significant lacuna is the lack of a system-wide climate risk assessment. Bangladesh Bank has not yet conducted a formal climate stress test. Consequently, there is no quantitative, forward-looking understanding of how a severe drought, a major cyclone, or a rapid global transition away from fossil fuels would impact the solvency of its banking sector. This leaves the financial system flying blind into a storm.
- Limited Use of Core Monetary Policy Levers: BB's sustainable finance operations are largely siloed within its supervisory and credit-directing functions. Its core monetary policy instruments - the policy rate, reserve requirements, repo operations, and its own balance sheet management - remain largely "climate-colorblind."
 - There are no green differentiated reserve requirements to incentivize green lending.
 - Its collateral framework for repurchase agreements does not distinguish between green and brown bonds.
 - It does not offer targeted refinancing lines at concessional rates for green projects, a tool powerfully used by the PBoC.
- Data Gaps and Disclosure Shortfalls: While BB collects vast amounts of data on green finance *outputs*, the data on *risk* is weak. Mandatory, granular TCFD-aligned disclosures from financial institutions and listed corporations are not yet required. This lack of high-quality, comparable data is a fundamental barrier to accurately pricing risk.

In essence, Bangladesh Bank has successfully built a channel for green credit but has not yet rewired the financial system's core circuitry to recognize and respond to climate risk automatically. It is managing a niche, not transforming the whole.

International Benchmarks: Lessons from the Frontier

To chart a path forward, Bangladesh can look to the practices of central banks that are further along this journey. The approaches of the PBoC and the ECB offer complementary models.

The People's Bank of China (PBoC): Strategic Credit Guidance

China, facing severe environmental degradation, has taken a direct and interventionist approach. The PBoC has powerfully embedded green objectives into its monetary policy framework:

- Green Finance Inclusion in Macro-Prudential Assessment (MPA): The MPA, a comprehensive scoring system for banks, now includes green credit performance as a key indicator, directly influencing a bank's ability to access central bank liquidity.
- Carbon Reduction Support Facility (CRSF): This is a direct monetary policy tool. The PBoC provides low-cost funds to commercial banks specifically for lending to clean energy, energy conservation, and carbon reduction technologies. The interest rate is as low as 1.75%.
- Green Bond Collateral: The PBoC accepts green bonds as collateral in its medium-term lending facility, making them more attractive for banks to hold.

The lesson for Bangladesh is the power of incentivization through core monetary tools. The PBoC has made it financially rewarding for banks to be green.

The European Central Bank (ECB): A Risk-Based Approach

The ECB's approach is grounded in its price stability mandate and a rigorous, risk-based methodology:

- Climate Stress Test: In 2022, the ECB conducted a pioneering economy-wide climate stress test, revealing that banks faced significantly higher default probabilities from their

exposures to carbon-intensive firms under a disorderly transition scenario.

- **Tilted Corporate Bond Portfolio:** As part of its monetary policy asset purchases, the ECB has begun to tilt its corporate bond holdings towards issuers with better climate performance. It is actively decarbonizing its portfolio, moving away from the "market neutrality" principle.
- **Enhanced Disclosure Requirements:** The ECB requires banks to meet strict climate risk disclosure benchmarks and has begun to impose capital add-ons for banks that are persistently lagging.

The lesson for Bangladesh is the primacy of risk management and disclosure. The ECB is using data and supervision to force the financial system to internalize climate risks. For Bangladesh Bank, the synthesis is clear: it must blend the strategic credit guidance of the PBoC with the rigorous risk-based supervision of the ECB, tailored to its own institutional context and development needs.

A Roadmap for Bangladesh Bank: A Three-Horizon Transition

The transition to a sustainable central banking model cannot happen overnight. We propose a phased, three-horizon roadmap to guide Bangladesh Bank's evolution systematically and sustainably.

Horizon 1: Strengthening the Foundation (2025-2027)

- **Mandate TCFD-aligned Disclosures:** Make it mandatory for all listed companies and financial institutions to disclose climate-related financial risks per TCFD/ISSB standards. This creates the essential data infrastructure for all subsequent actions.
- **Develop and Pilot a Climate Stress Test:** In collaboration with the NGFS and using their scenarios, BB should initiate a pilot climate stress test for the top 10-15 banks. The focus should be on capacity building and understanding key transmission channels.
- **Launch a Targeted Refinancing Scheme:** Establish a dedicated fund, akin to the PBoC's CRSF, to provide banks with low-cost, long-term

funding for priority green sectors identified in the Mujib Climate Prosperity Plan (e.g., climate-resilient infrastructure, renewable energy).

Horizon 2: Deepening Integration (2028-2030)

- **Institutionalize and Scale Stress Testing:** Integrate climate stress testing into the annual supervisory cycle. Use the results to inform Pillar 2 capital guidance (i.e., recommending banks hold additional capital against climate risks).
- **Explore a "Green Supporting Factor":** Conduct a thorough impact assessment on the potential for introducing a modest, evidence-based green supporting factor in bank capital requirements for specific, low-risk green assets.
- **Reform the Collateral Framework:** Begin accepting bonds certified under Bangladesh's own green bond taxonomy as collateral in BB's repo operations, potentially with a modestly preferential haircut to boost demand.

Horizon 3: Strategic Alignment (2031 and Beyond)

- **Formalize the Expanded Mandate:** Work with the government to potentially amend the Bangladesh Bank Order to explicitly recognize managing climate-related financial risk as a secondary objective supporting its financial stability mandate.
- **Fully Integrate Climate into Monetary Policy:** Consider a systematic "tilt" of BB's own portfolio towards sustainable assets, should it ever engage in significant asset purchase programs.
- **Lead a Whole-of-Economy Transition:** Position BB as the nodal agency for coordinating a national climate finance strategy, ensuring alignment between monetary policy, fiscal policy (e.g., carbon pricing), and the capital markets.

4. Conclusion and Recommendations

The climate crisis is no longer a distant threat; it is a present and escalating risk to Bangladesh's hard-won economic prosperity. This paper has argued that Bangladesh Bank, despite its pioneering status in green banking, must urgently accelerate its transition to a more robust and integrated sustainable central banking model. The current compliance-based app-

roach, while successful in mobilizing green credit, is insufficient to safeguard the financial system from the systemic nature of climate risk or to mobilize capital at the scale required by the nation's climate ambitions. The readiness of Bangladesh is thus a story of potential, not completion. The foundational policies are in place, but the advanced tools of risk management and market incentivization are not. The proposed three-horizon roadmap provides a pragmatic pathway for this evolution, moving from building data and supervisory capacity to actively steering the financial system.

The policy implications are profound. For the government, it necessitates close collaboration with BB and potentially a legislative review to clarify mandates. For BB's leadership, it requires a strategic decision to invest in new skills, models, and a potentially more interventionist posture. For the financial sector, it heralds a future where climate competence will be a core determinant of profitability and survival. The window for a managed transition is narrowing. By embracing its role as a steward of a climate-resilient financial system, Bangladesh Bank can do more than just protect its balance sheet—it can help secure the nation's economic future. The journey from a green banking pioneer to a sustainable central banking leader is the next necessary step in Bangladesh's remarkable development story.

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6. Conflicts of Interest

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