

Transition Risk, Preference Shocks, and Climate Policy*

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Abstract

The financial stability risks associated with decarbonization are a growing concern for policymakers and financial institutions. This paper studies the macroeconomic consequences of transition risk in an environmental dynamic stochastic general equilibrium model with a frictional financial sector. We analyze three sources of transition risk: one policy-driven source of transition risk arising from an increase in carbon tax, and two preference-based sources: a shock to consumer preferences and a shock to investor preferences. For a given emissions reduction target, preference shocks generate larger macroeconomic and financial instability than a carbon tax while delaying environmental benefits. We further show that a tax-and-subsidy scheme on banks' asset holdings mitigates these adverse effects and brings the economy closer to a first-best scenario, where environmental externalities and financial frictions are absent. Overall, carbon pricing and targeted financial sector policies play a central role in mitigating transition risks, ensuring a more stable adjustment path and leading to a long-run equilibrium with fewer distortions.

JEL Classifications: E32; E60; G18; Q43; Q58.

Keywords: Transition Risk; Financial Frictions; Climate Policy; Preference Shocks; Macroprudential Policy.

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