Citizens, Narrative Economics and Monetary Policy: The Bank of Italy Arithmetic on Italy

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Motivation

- Motivation: Citizens and Monetary Policy – Conventional and Unconventional Channels
- Key Relationship: Sentiments (Beliefs), Narratives and Monetary Policy
- A case of Central Bank Narrative on Monetary Policy: The BI Arithmetic on Italy
Motivation: Citizens and Monetary Policy

- Citizens and Monetary Policy: **Two-Way (Intertwined) Channels**:
  - 1) **Conventional** Channel: Expectations and Monetary Policy (Barro and Gordon 1983)
  - 2) **Unconventional** Channel: Voting on Central Bank Governance: Voters, Politicians, Demand and Supply of CBI (Masciandaro and Passarelli 2018)
- On Top: **Narrative Economics** (Shiller 2017) and the role of Facts, Perceptions and Tales in Shaping Sentiments (Beliefs)
- Governor’s Concluding Remarks: a case of **Central Bank Narrative**
- **Background**:
  - Monetary Policy and Central Banking before the Great Crisis: A **Well Established** Narrative
The “Old Normal” Narrative: The Monetary Policy Setting during the Great Moderation

- The **three pillars** of the monetary setting during the Great Moderation:
  - 1) Monetary Policy **Goal**: Macroeconomic Stability (Output Growth + Inflation) with a special focus on Monetary Stability
  - 2) Monetary Policy **Tool**: Nominal Interest Rate
  - 3) Monetary Policy **Actor**: Independent Central Bank
Monetary Policy: Goal and Tool. Being in Equilibrium and Without Shocks...

- The Nominal Interest Rate is: $i = r^* + \pi^*$

$$y = y^*$$

$$\pi = \pi^*$$

$$r = r^*$$
But **Macro Shocks** can occur, and the **Central Bank** have to react ...

**Monetary Policy: ... and with Shocks**

**The Fed’s Dual Mandate**

Loss Function: \( L = (\pi - \pi^*)^2 + (u - u^n)^2 \)

(percentage deviation from target)

- **Core Inflation**
- **Unemployment Rate**
Monetary Policy: Goal + Tool = The Taylor Rule

\[ i_T = r + \pi + \alpha(\pi - \pi^*) + \beta(y - y^*) \]

• ... Using a monetary rule = anchor for agent expectations and behaviour
• With its more common specification, i.e.
  • with \( r^\wedge = \pi^* = y^* = 2 \) (historical data)
  • and \( \alpha = \beta = 0.5 \) :
    \[ i_T = 1.5\pi + 0.5y \]
• That stresses the dominant role of monetary stability
• In fact ...
Monetary Policy and Monetary Stability: The Best Practices

**Figure 1** National MPs: Aggregation by target variable, advanced countries
The Monetary Actor: Before the Crisis

Society

Politicians

Accountability

Independent Central Bank

Banking Industry

Monetary Policy
Why the modern central bank is designed in order to be independent from the government?

The politicians tend to use the monetary tools with a short sight perspective, i.e. to smooth different kind of macroeconomic shocks – unemployment, fiscal deficit financing, banking bailouts - in order to have immediate political gains and postpone – or hide – the corresponding costs.
Central Bank: Why Independent? Rationale ...

- ... the more the markets are efficient, the greater the risk that the short sighted monetary policies produces just distortions (inflation and/or bubbles)
- The monetary policy becomes time inconsistent (non credible)
- Risks of Bad Macro Outcomes: Stagflation, Debt Monetization Imbalances, Bank Bailout Imbalances
- Solution ...
Central Bank: Why Independent? ... and Robustness

- CBI and Macro Performances:
  - Nominal variables: YES
  - Real variables = ?
  - Fiscal variables = ?
  - CBI as a free lunch

Source: Masciandaro and Romelli, 2015
The Meaning of Independence

- The establishment of an independent central bank is a solution to have a credible monetary agent without short term biases.
- CB Institutional (governance) properties:
  - 1) Monetary Stability Goal (Conservativeness)
  - 2) No Public Deficit Monetization
  - 3) No Banking Policy Powers
  - 4) Accountability
- Benchmark ...
The ICB: The ECB
The Great Crisis

Figure 1. Per capita GDP
Constant prices; 2010 = 100

Source: International Monetary Fund, World Economic Outlook database
After the Crisis: Sentiments, Monetary Policy and Central Banking

- Narrative News: The case of Euro
- 1) Europhilia and ECB Monetary Policy
- 2) Politics and ECB Governance
1) Europhilia and ECB Monetary Policy

Figure 2. Evolution of positive sentiments about membership in European Union (E. U. 15)
Share of respondents who answer “Good” to the question “Generally speaking, do you think that (OUR COUNTRY)’s membership of the European Union is ...?” Answers were on a 3 point scale (Good, Neither good nor bad, Bad). In Panel A the data are arranged by geographic subdivisions in E.U. 15. North: Denmark, Sweden, Finland, United Kingdom, Ireland. Centre: Austria, Germany, France, Belgium, The Netherlands, Luxembourg. South: Italy, Greece, Spain, Portugal. In Panel A, to deal with potential compositional effect due to new accessions to the E.U. we have assigned to each country its entry-year membership score in each year before entry (applies to Greece, Spain, Portugal, Finland, Sweden, Austria). Each country weighs according to its specific sample size (sample at entry-year for post-1973 entrants). In Panel B, C and D the data for each individual country is shown with no backfilling. Source: Eurobarometer surveys from 1973:1 to 2012:1.

Source: Guiso, Sapienza, Zingales, Monnet’s Error?, 2015
Figure 3. Differences across time in positive sentiments toward membership in European Union
Year fixed effects derived from an OLS regression using individual level data and regressing sentiments towards E.U. membership on individual demographics. Sentiments toward EU membership are derived from the question “Generally speaking, do you think that (OUR COUNTRY)’s membership of the European Union is ...?” Answers were on a 3-point scale (“Good”, “Neither good, nor bad,” “Bad”). We coded the question as a dummy variable equal to one if the respondent answered “Good.” Individual demographics: gender, cohort (omitted cohort: born before 1945), education, occupation (omitted job: farmer/fisherman), country fixed effect (omitted country: Germany) and year fixed effect (omitted years: 1973 for the top quadrants, 2002 for the bottom quadrants). Sample period: 1973-2012. For all variable definitions see Appendix.

Source: Guiso, Sapienza, Zingales, Monnet’s Error?, 2015
Note: Data on Sentiment & MP - Handle with Care

Figure 2. IMD Reputation Measure for BOE vs. BOE’s Large Survey Results on Public Satisfaction with BOE’s Handling of Interest Rates and Inflation

Source: Hwang, 2018
Europhilia and ECB Monetary Policy

Divergence of trust on Euro and trust towards E.C.B. in selected countries

Source: Guiso, Sapienza, Zingales, Monnet’s Error?, 2015
Europhilia and ECB Monetary Policy

Distance of national Taylor rule from ECB rate (post 1999)

Source: Guiso, Sapienza, Zingales, Monnet’s Error?, 2015
2) CBI and Populism

- The populist movements, which share a demand for short-term protection, appear to be characterized by three main properties:
  
- 1) the claim that they protect the people from the elite (redistributive goal), 2) certain demand conditions and 3) a disregard for future consequences (Guiso et. Al. 2017)

- A Populist policy is both redistributive (1) and myopic (2+3).

- Populist policies present solutions that are welfare enhancing in the short run for a selected constituency, which is today the majority of the population, but costly tomorrow for the overall population
CBI and Populism

• “with their PhDs, exclusive jargon, and secretive meetings in far-flung places like Basel and Jackson Hole, central bankers are the quintessential rootless global elite that populist nationalist love to hate” (Rajan 2017)

• The narratives of central bankers seem to sketch them out as a natural target for populist policies
ECB and Populism

- On the ECB rules:
- «Asphyxiating rules (...) written by the Bundesbank»
- Yanis Varoufakis,
  Greece Finance Minister, Conference Press, March 2015
Sentiments and Central Bankers
Euro and Italian Macro Performances: The Bank of Italy Arithmetic

- Narrative: European Monetary Policy and Italian Macro Performances

- “We are not constrained by the European rules but by economic logic” (Vincenzo Visco, p.18)
Memo: Euro and Italian Macro Performances

Fig. 3
GDP at constant prices (rates of change)

Note: This figure is described on page 11

Source: Baffigi, Bank of Italy, 2011
Memo: Euro and Italian Macro Performances
Memo: Euro and Italian Macro Performances

Figure 1: Inflation, 1946 – present

Annual growth rates of the consumer price index, 5-year moving averages.

1979 = ERM=
European Exchange Rate Mechanism

Source: Panetta, Monetary Policy in the Euro Area, April 2018
Euro and Italian Macro Performances: The Bank of Italy Arithmetic

- Italy anaemic growth and high public debt (DEBT/GDP=132)
- Funding demand = 400 billions per year
- D/G Drivers: primary fiscal balance (PFB) + (r-g)
- Given monetary stability + ECB MP normalization:
  - with PFB = 3-4 D/G <100 up to 2028
- Bank of Italy Arithmetic as Narrative Benchmark

Figure 7

Ratio of public debt to GDP in Italy: scenarios

Sources: Based on Bank of Italy and Istat data.
A Note: Sentiments, Politics and Central Banking
- An Ongoing Case Study

. Turkey 2018

Source: FT, May 25, 2018
That's all Folks!