# POPULISM, POLITICAL PRESSURE AND CENTRAL BANK (IN)DEPENDENCE

Donato Masciandaro and Francesco Passarelli

Bocconi University

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# Abstract

- It is possible to design a relationship between populism and central bank independence (CBI)?
- Yes, given three key assumptions:
- Heterogeneous voters
- Populist policy = myopic and redistributive action
- CBI = central banker as a long sighted player

# Motivation (FT, November, 2019)

FINANCIAL TIMES

FRIDAY 1 NOVEMBER 2019 — WORLD BUSINESS NEWSPAPER — EUROPE

**Independence Jay**
White House bullying will not work on the Fed chair — GILLIAN TETT, PAGE 9

**Floating away**
Private money is luring companies from listings — BIG READ, PAGE 7

**Lingua franca**
French elite's penchant for classics is authentic — PARIS NOTEBOOK, PAGE 8

## Do not underestimate Powell in a fight

FINANCE — Gillian Tett

Economists from Duke University and London Business School recently published research into a once-unthinkable – but now timely – question: how much market impact does a presidential Twitter attack on the US Federal Reserve actually have?

The answer offers reasons for hope – and fear. On the upbeat side, the tangible market impact of Donald Trump's demands for looser monetary policy have been modest so far, the research suggests; the implied yield on Fed Funds futures contracts apparently declined by an average of 0.30 basis points after each attack, producing "the cumulative effect of around negative 10 bps" so far. This is so small in the wider scheme of things that it would undoubtedly disappoint Mr Trump in the (unlikely) event he read this research.

What is less cheering is that the fact futures prices moved at all after Mr Trump's tweets suggests that "markets do not perceive the Federal Reserve Bank as a fully independent institution immune from political pressure", the economists argue. There is, in other words, already some implied damage.

Despite the Fed's rate cut on Wednesday, the fight between it and Mr Trump will probably get worse, not better, in the coming year. There are two reasons for this. One obvious factor is that the White House is desperately hunting for scapegoats for the current slowdown in US growth. In public, Mr Trump is ebullient: after it emerged this week that the economy had grown 1.9 per cent in the third quarter, the president saluted "The Greatest Economy in American History!" on Twitter.

However, there has also been a sharp fall in business investment and exports. You do not need to be a genius to spot the cause of this malaise: trade wars have injected deep uncertainty into the business outlook. This won't disappear even if the White House cuts a trade deal with China, since few executives trust that a truce will last.

Since the White House does not want to blame any slowdown on its own policies, it insists that any looming weakness reflects the fact that US borrowing costs are higher than in Europe or Japan, fuelling dollar strength. In other words, White House officials want to use rate cuts as a tool in their bigger geopolitical currency and trade war as the 2020 election looms.

> Having built a career in private equity, the Fed chair has ample experience with aggressive bullies

The second reason the battle will probably become uglier is that Fed officials seem unlikely to play ball with Mr Trump. That may not seem obvious from the Fed's decision this week to cut rates by 25 basis points for the third time this year. However, the rate cut occurred in spite of Mr Trump's broadsides, not because of it. Fed officials genuinely believe that growth is slowing down – those pesky trade wars have offset much of the beneficial impact of the 2017 tax cuts – and they want to offset the risks.

It is striking that Fed chair Jay Powell suggested on Wednesday he does not expect to cut rates again soon unless consumer activity declines. He does not want Fed policy be a tool in the currency and trade war. This stance reflects a mood of quiet militancy inside the central bank, where officials are determined to fight what some describe as an "existential threat" to its independence.

But it also raises another, oft-overlooked point: Mr Powell's persona. When he was first appointed chair in February 2018, some observers doubted whether he would have the stomach for a fight. He has a genial demeanour, and sometimes weak communications style.

Moreover, Mr Powell is not part of the central banking club of esteemed economists. He is the first Fed chair in four decades without an economics doctorate let alone a degree, having trained as a corporate lawyer. He is also a longtime Republican – which is precisely why Mr Trump appointed him.

But that assessment overlooks the fact that Mr Powell built his career (and wealth) in the vicious world of private equity as a Carlyle partner. Genial or not, he has more experience with aggressive bullies than any recent Fed chair. He also knows how to use the law as a shield and a weapon – specifically the 1913 Federal Reserve Act that protects his independence.

Precisely because Mr Powell is not an economist, and a pragmatist rather than an ideologue, he listens to his central bank peers and Fed staff. This has left him as determined as they are to fight the threat to Fed independence.

If the growth keeps slowing, the stage will be set for an intensifying battle between Messrs Powell and Trump. It is still alarmingly unclear who will eventually triumph on the question of rates – and the Fed's independence. My money is still narrowly with Mr Powell, despite that 10bp market swing.

gillian.tett@ft.com

## Tribe of central bankers in eye of political storm

Economic danger greatest in emerging markets with weak institutions

CHRIS GILES — LONDON
SAM FLEMING — WASHINGTON

The technocratic tribe of central bankers is facing political scrutiny of an intensity not seen in decades.

President Donald Trump ramped up his war of words with the US Federal Reserve, accusing it of having "gone crazy" by raising interest rates and expressing public regrets over his choice of Jay Powell as its chairman.

The Reserve Bank of India has been under pressure to ease lending conditions, while Hungary has tussled with the EU over measures impinging on its central bank's independence. Turkish president Recep Tayyip Erdogan has shaken market faith in his nation by leaning on its central bank to keep rates low.

Even the normal brotherhood of central bankers is fracturing with Mervyn King, former Bank of England governor, accusing his successor, Mark Carney, of "unnecessarily" pandering to the UK government's Brexit desires. Charlie Bean, former deputy governor to both men, said that such questions over central banks' independence will not go away given the scope of their powers in politically contentious areas. "This area is going to be more fraught in the future than it has been in the past," he said.

Central bankers are likely to be unenthusiastic about such challenges after a decade in which their influence grew because of the crucial role of monetary policy in responding to the financial crisis. But while they are in the eye of the political storm in countries such as the US and the UK, the economic danger is greater in emerging economies where institutions are often weaker and from which money is more likely to flee.

At stake is the trend, which gathered pace in the 1990s, of giving central banks independence to undertake monetary policy. Most research suggests the



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# Motivation (FT, July, 2019)

FINANCIAL TIMES

MONDAY 8 JULY 2019 WORLD BUSINESS NEWSPAPER EUROPE

**Hong Kong divided** Escalating tension leaves business in a bind over unrest — PAGE 3

**New superpowers** The US, China & Silicon Valley vie for supremacy — RANA FOROOHAR, PAGE 17

**Strike for climate** Green protests are coming to an office near you — PILITA CLARK, PAGE 18

Monetary policy

## Turkish financiers vexed by central bank sacking

LAURA PITEL — ANKARA

Few Turkish financiers expected to find themselves defending Murat Cetinkaya, who was fired as central bank governor after three years in office often marred by erratic and unorthodox policymaking.

But Mr Cetinkaya's dismissal over the weekend by Recep Tayyip Erdogan, the president, after a clash over the pace of interest rate cuts drew howls of outrage.

"Removing the central bank's governor in this manner will deal a big blow to its institutional structure, capacity and independence," Ibrahim Turhan, a former deputy central bank governor, wrote on Twitter.

The manner of Mr Cetinkaya's departure means that Murat Uysal, his successor, who was his deputy, risks being seen as beholden to the president. Faik Oztrak, a former Treasury official and a member of the main opposition party, said the central bank had become a "prisoner of the presidential palace".

The firing has added to investor concerns about Mr Erdogan's dominance over all areas of government policy, including economic management.

Some fear that pressure on the governor to cut rates could propel Turkey

...

president, whom Mr Cetinkaya had not seen one-on-one for almost a year.

Mr Cetinkaya angered Mr Albayrak by refusing to cut rates at the last meeting of the monetary policy committee in June. They tussled again over the plans for the next meeting, planned for late July, when Mr Cetinkaya was willing to lower rates — but not as much as Mr Albayrak wanted. Mr Erdogan warned last month that high rates were "hurting" Turkey and promised that a "definitive solution" would be found soon.

Less than three weeks later, Mr Cetinkaya, who refused to resign, was fired. Legal experts said the sacking, by presidential decree, was illegal.

A finance ministry spokesman did not respond to a request for comment. But Mr Erdogan all but confirmed the dispute over rates at a meeting of ruling party MPs on Saturday, according to Turkey's Hurriyet newspaper.

It is unclear how the new governor will fare. One financier described the

'We haven't even resolved the first crisis yet. Another hit is only going to make things worse'

# Motivation (FT, June, 2019)

FINANCIAL TIMES

WEDNESDAY 12 JUNE 2019 — WORLD BUSINESS NEWSPAPER — EUROPE

**Martin Wolf**
Choosing Jens Weidmann to head the ECB would be a big risk — PAGE 9

**Books and mortar**
Why Amazon has failed to kill off the physical bookstore — BIG READ, PAGE 7

**Algerian spring**
Hopes are rising for a peaceful transition — GLOBAL INSIGHT, PAGE 3

South Africa. Monetary policy

## Attack on central bank adds to Ramaphosa woes

**President's allies believe ANC rivals are deliberately picking a fight over SARB's powers**

JOSEPH COTTERILL — JOHANNESBURG

Cyril Ramaphosa's uphill battle to revive Africa's most industrialised economy has grown steeper after his ruling African National Congress spooked markets with an attack on the independence of the central bank.

South Africa's economy is already edging towards recession and threats to growth are stirring up problems for the president after the ANC returned to power in elections in May.

Now Mr Ramaphosa has to defuse a nationalise an unusual private shareholder structure. There are also calls to add growth and employment to the bank's inflation target.

The arguments have been described by Lesetja Kganyago, SARB governor, as a "Trojan horse" threatening the bank's autonomy.

Mr Ramaphosa said that the rancorous debate was "undermining the confidence of citizens and of investors".

The storm broke last week when Ace Magashule, the ANC's powerful secretary-general, said that the bank's mandate would be expanded alongside approval to explore quantitative easing or central bank asset purchases.

But he was flatly contradicted by other party figures such as Tito Mboweni, the finance minister and former

The furore reflects fears of a return to the systematic undermining of independent institutions that was rife under Jacob Zuma before the ANC replaced him as president last year. It has also exposed the fragility of his successor's grip on power within the party.

Mr Magashule is an old Zuma ally fighting allegations that he took part in

Cyril Ramaphosa: president says debate undermines the confidence of citizens and of investors

looting of the state under the former president. Both men deny the claims.

Supporters of Mr Ramaphosa believe

tion manifesto, too. ANC-linked trade unions that are allies of Mr Ramaphosa also want change.

Many in business backed Mr Ramaphosa to bring economic stability but "people have relied on the inability of the ANC to implement its own resolutions", Lukhona Mnguni, a political analyst, said.

Mr Zuma's allies have taken the opportunity to make mischief as a result, irrespective of the economic threat, analysts and policymakers said.

Despite the furore over the reserve bank having private shareholders, a relic of its history, they have no control over policy.

Monetary policy meetings also already take into account growth and unemployment, though the reserve

# Motivation (WSJ, March, 2019)

4/4/2019 World News

**THE WALL STREET JOURNAL.**

## Italy's Ruling Populists Covet The Central Bank—and Its Gold

By Giovanni Legorano

ROME—Italy's ruling populists pushed ahead this week with efforts to seize control of the central bank and its gold reserves, stepping up their confrontation with a symbol of the country's establishment.

With two laws targeting the Bank of Italy under debate in Parliament, the campaign is the latest attack on Italy's independent institutions by leaders of the governing coalition, which is led by the antiestablishment 5 Star Movement and the nativist League.

The parties depict the central bank as a symbol of a technocratic elite aloof from the needs of ordinary Italians. Hundreds of thousands of small individual investors lost billions of dollars after several Italian banks failed in recent years, causing widespread anger against the Bank of Italy and previous governments.

"We need a change of course at the Bank of Italy if we think about what happened in the last years," Deputy Prime Minister Luigi Di Maio, leader of the 5 Star Movement, said in February.

ment were to become the owner of the Bank of Italy, its independence would still be granted by Italian and European laws.

Independent institutions, however, are a bugbear of populist politicians who say that all government should be a direct expression of the popular will, which they claim they themselves represent. Italy's leaders have consistently accused independent institutions of trying to frustrate the popular will.

5 Star and the League have attacked the Bank of Italy for not preventing the banking crises, and blamed it for the losses suffered by mom-and-pop savers who had bought bank shares and bonds.

"If you are here with your current account in the red, it's because the people who were supposed to control things didn't do so," League's leader, Interior Minister Matteo Salvini, told a group of former investors in Banca Popolare di Vicenza, which was liquidated in 2017, in February.

That month, Messrs. Salvini and Di Maio said the central bank's top brass should be replaced because it had failed to

# Motivation (FT, December, 2018)

Newspaper of the Year

**FINANCIAL TIMES**

TUESDAY 11 DECEMBER 2018 | WORLD BUSINESS NEWSPAPER | EUROPE

## India central bank governor quits after dispute over independence

- Patel's exit follows demands from Modi
- Rupee falls 1.8%
- Analysts warn of sell-off

AMY KAZMIN — NEW DELHI
SIMON MUNDY — MUMBAI

The head of India's central bank abruptly resigned yesterday in the midst of a bruising battle with the prime minister over the institution's independence and the future direction of the country's financial sector.

Urjit Patel's exit comes just days ahead of what was likely to be a contentious meeting of the Reserve Bank of India's governing board, where Prime Minister Narendra Modi's demands for looser financial and monetary policies were scheduled for debate.

Tensions between the RBI and Mr Modi have been building for months over the central bank's hawkish monetary policy, use of its mounting reserves and the tough measures taken to clean up bad loans at India's state-run banks.

Mr Modi has been accused of demanding the RBI ease back on its crackdown out of fear it would hit economic growth during his drive for re-election, particularly as liquidity in non-bank lenders has dried up after a series of defaults at IL&FS, a high-profile finance and infrastructure group.

At a 10-hour board meeting last month, Mr Patel made a number of concessions under pressure from government nominees, including promising to review restrictions on lending by banks that already have high levels of bad debt. Pressure on the RBI was expected to continue at Friday's meeting.

In a statement on the RBI website, Mr Patel cited "personal reasons" for his decision to step down. He becomes the second central bank chief in a row to depart unceremoniously, having taken over in September 2016 after the government failed to extend Raghuram Rajan's tenure. Mr Patel's departure is effective immediately.

"I don't think he wanted to go down in history as somebody on whose watch the RBI was put through an unreasonable wringer," said Rajeev Malik, a strategist at River Valley Asset Management.

Mr Rajan urged New Delhi to tread cautiously and "act appropriately" after the departure. He told Indian television that the resignation was "a statement of dissent and therefore the government has to be very careful in dealing with it, to ensure the credibility of the institution is preserved".

But some analysts said it may be too late for the RBI to maintain independence, arguing that the resignation was a signal Mr Modi had won the battle.

Pressure was expected to build at a Reserve Bank of India board meeting on Friday

"By forcing Mr Patel's hand, the government has now made it clear who runs the show," said Eswar Prasad, a professor at Cornell University.

India's rupee fell 1.8 per cent against the dollar and analysts warned of a further sell-off unless the government moved quickly to restore faith in the central bank — particularly with three closely watched state elections scheduled for today seen as dress rehearsals for next year's general elections.

"In the next 24 hours, New Delhi will have to step up and play a stellar role to reinforce market confidence in the RBI," said Saurabh Mukherjea, founder of Marcellus Investment Managers.

# CBI: Motivation (1/2)

- Given the state of the art in the literature on the relationships between governments and central banks (CBI):
- Five Research Questions:
- 1) Which is the difference between politicians and populists?
- Answer: populist = politician (myopic player) with a redistributive aim
- 2) Which is the difference between de jure and de facto CBI?
- Answer: political pressure = demand for CBI reform

# CBI: Motivation (2/2)

- Given the state of the art in the literature on the relationships between governments and central banks (CBI):
- Research Questions:
- 3) Via CBI how many economic policies can be influenced?
- Answer: Three policies: monetary, fiscal and banking policies
- 4) Via CBI how many macro outcomes can be influenced?
- Answer: Growth, Inflation, Fiscal and Financial Outcomes
- 5) Which are the effects of assuming heterogeneity instead of homogeneity among citizens (voters)?
- Answer: Political Pressure is more likely to occur

# Populism: Motivation

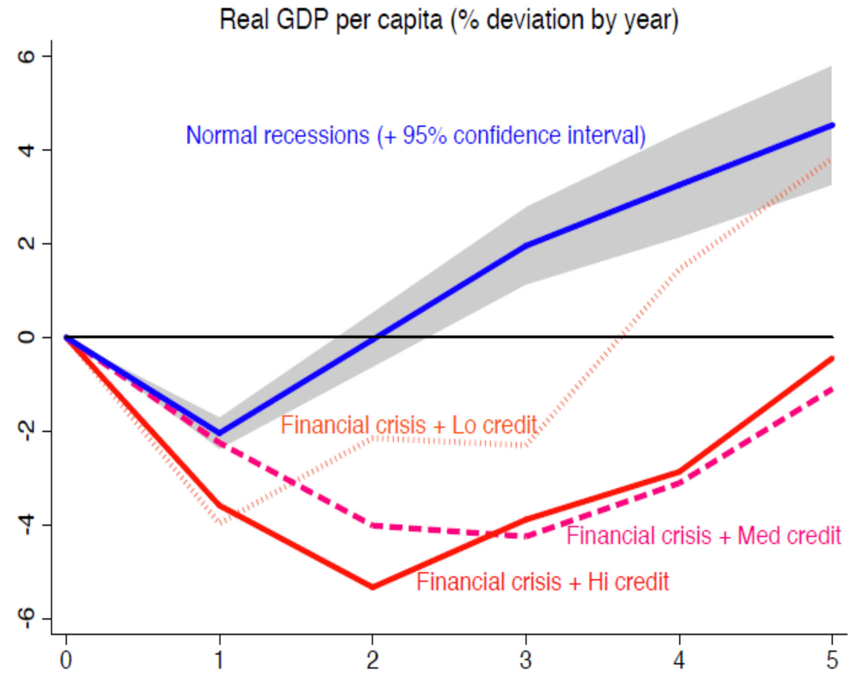
- Two Research Questions , given the debate on:
- 2) Economics vs Culture as Drivers of Populism: Can an economic shock be relevant in explain Populism?
- Answer: Yes , when a Balance Sheet Recession occurs and the voters are heterogeneous
- 3) Populism and Institutions: How to explain a Populist Pressure against the Monetary Veto Player, i.e. the Central Bank?
- Answer: when the majority of citizens dislike a long sighted monetary policy
- Before to go ahead, three key clarifications …

# Macro Shock: Balance Sheet Recession Risk

- Economic Hardship = Balance Sheet Recession (BSR) Risk
- Economically Painful: the BSRs are most prolonged and painful (Jorda et al. 2015)
- Politically Risky: the BSRs are more like to produce political polarization and government instability (Funke 2015)

Figure 2: Unconditional Paths

(a) Discrete excess credit treatment




Source: Jorda et al. 2015

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# Populism and Economic Policies

- Populism appears to be characterized by two main properties (Guiso et al. 2017, Rovira Kaltwasser 2018):


- 1) the claim that they protect the people from the elite = Protection Bias
- 2) pandering certain demand conditions, disregarding future consequences = Concealing Bias
- Translating from political analysis to economics:
- Assumption: Protection = Redistribution; Concealing = Short Termism


Wednesday 24 April 2019 ★ FINANCIAL TIMES

# Populism and Veto Players

- Given the general debate on:
- 3) Populists vs Veto Players:
- In general "populism maintains a difficult relationship with liberal democracy (…) as characterized by the existence of autonomous institutions that are neither directly controlled nor directly elected by "the people" " (Rovira Kaltwasser 2018)
- This is why populist forces are inclined to enact reform that allow them to get rid of the so called checks and balances as well as to exercise direct control over autonomous institutions" " (Rovira Kaltwasser 2018)
- And in particular …

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# Populism and Monetary Veto Players

- Given the debate on:3a) Populists vs Monetary Veto Players: “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

- Populists dislike monetary dominance (Edwards 2019)

# Presentation Setup

- The State of the Art (NO)
- The Framework: Populists, CBI, economic policies
- Conclusion

# The Framework: A Macro Crisis and Four Players

- Theoretical Framework:
- A model that mimics an economy in which a systemic banking shock can occur
- The policymakers have design a policy involving banking, fiscal and monetary aspects aimed at minimizing the spillover effect of such a shock into the real sector
- Given the time schedule:

| **0** *Safe and sound banking* | **1** *Systemic crisis: Banking, debt and monetary policies* | **2** *Fiscal policy, labour markets, consumption and growth* |
| --- | --- | --- |
| I NORMAL TIMES | I EXTRAORDINARY TIMES | I NEW NORMAL |

- The players: 1) banks, 2) government, 3) central bank 4) citizens , with their human and financial assets

# Normal Times: Banks and Banking Policy 1/3

- The sequence of events is as follows:
- At t=0, banks engage in business with some level of risk (*normal times*).
- The outcome of these activities determines the extent to which the bank's risk profile is safe and sound. Without a bank crisis, no policy trade offs have to be addressed
- In normal times, a banking crisis – with its probability $p(r)$ - can occur if the bank is unable to meet its obligations
- The bank chooses the risk profile **r** that maximizes its own expected equity value, also the bailout likelihood β into account: $p(r(\beta))$
- Given uncertainty, an endogenous lever is the banking policy

# Extraordinary Times: Government, Banking and Fiscal Policy 2/3

- At t=1, bank failures can occur and, consequently, the policymakers has to design their strategy (*extraordinary times*)
- The public policy involves two government decisions, given the central bank decision (monetary dominance):
- One regarding the banking policy $\beta$ (i.e. the degree of the bail-out)
- and another regarding the corresponding fiscal policy $\tau$ to finance the bailout via bond issuing
- taking into account the monetary policy – i.e. the debt monetization $\delta$ - that depends on the central bank decisions
- In other words ..

# Extraordinary Times: The Government Trade Off: Debt/Tax or Banking Instability? (2/3)

- When a bank fails, the government faces a trade-off: let the bank fail - no debt/tax distortion - or rescue it by injecting new capital – no banking externalities, which hit the citizens
- In the latter case, the government issues public debt for the amount of the bailout
- Public bonds can be purchased by either citizens or the central bank
- The central bank's purchases represent the monetization $\delta$
- Regarding the central bank we assume that its monetary choices are independent

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# Extraordinary Times: The Central Bank and its Monetary Policy (2/3)

- The central bank decides the debt monetization δ independently from the government, taking into account all the consequences:
- tax distortions η, including the banking externalities
- financial effects, proxied via the interest rate i
- monetary instability externalities φ
- $$\delta = \frac{\eta(\tau)}{1-\eta(\tau)}\frac{i}{\varphi}$$
- Why? 1) The central bank is a LT player – given its institutional setting – and 2) the central banker knows that the MP action can have conventional and unconventional effects …

# The Redistributive Effects (3D) of Monetary Policy

- The "3 D" effects:
- The directional effect captures the impact of public policy on a certain sector, for example the banking industry (ZIRP/NIRP), or the corporate sector (QE);
- The distributional effect results from changes in interest rates (ZIRP/NIRP,QE, FG)
- The duration effect measures the monetary policy's effect on overall public-sector liabilities. More monetization = less duration (ZIRP/NIRP) = more monetary instability
- In our framework …

| **Policy** | **Effect** |
|---|---|
| ZIRP/NIRP<br>QE | DIRECTIONAL |
| ZIRP/NIRP<br>QE<br>FG | DISTRIBUTIONAL |
| ZIRP/NIRP<br>QE | DURATION |

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# The Redistributive Effects and the 3 Economic Policies

- The “3 D” effects (Goodhart and Lastra 2018):
- The directional effect captures the impact of public policy on a certain sector = the banking industry;  here it  depends on the banking policy choices
- The distributional effect results from changes in interest rates; here it  depends on the fiscal  policy choices
- The duration effect measures the monetary policy’s effect on overall public-sector liabilities. More  monetization = less duration = more monetary instability; here it depends on the  monetary policy choices

| Policy | Effect |
|---|---|
| BANKING POLICY BAIL OUT: Y VS N | DIRECTIONAL |
| FISCAL POLICY DEBT VS TAX = i | DISTRIBUTIONAL |
| MONETARY POLICY DEBT MONETIZATION | DURATION |

# Note: Monetary Policy and 3 Redistribution Channels

- Monetary policy action generates 3 redistribution channels (Auclert 2019):
- The Fisher effect captures the different impact of (un)expected inflation
- The Interest Rate Exposure effect results from changes in interest rates (=distributional effect in the above taxonomy)
- The Earning Heterogeneity effect measures the monetary policy's effect on labour and profit earnings

| **Channel** | **OUR MODEL** |
|---|---|
| FISHER EFFECT | monetary instability sensibility = homogeneous |
| INTEREST RATE EXPOSURE | Financial assets = HETEROGENOUS |
| EARNING HETEROG ENEITY EFFECT | Labour income = homogeneous |

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# The Optimal Monetary Policy

- Being the central bank a LT player, she/he acts as
- A social planner, that simultaneously sets the policy strategy, in order to maximize the social-welfare function
- The optimal level of monetization increases: a) if tax-distortion risk is high, b) if the cost of debt servicing i is high and c) if the monetary-instability costs φ are low

$$\delta^* = \frac{\eta(\tau)}{1-\eta(\tau)}\frac{i}{\varphi}$$

# New Normal Times: Citizens and Policies (2/3)

- At t=2 ( "*new normal" times*)
- the government introduces an income tax to repay debt and interest
- The citizens make decisions about labour, consumption and income given the tax, as well as the values of the financial assets – banking assets and bonds – and the monetary instability externalities
- If the citizens are homogeneous – as in the traditional macroeconomic framework – the optimal monetary policy is the social optimal one
- i.e. no pressure to change the actual CBI

# But: Citizen Heterogeneity can Matters and …

- But: if the policies trigger heterogeneous effects on the citizens, different individuals will have different views regarding those policies
- This is crucial as long as the citizens' preferences are relevant in the political process
- Therefore, the preferred policy is not mechanically equal to the socially optimal one
- Which Heterogeneity? Our framework focuses on heterogeneity among citizens in terms of financial inequality

# … Citizens are Voters

- The redistributive effects are a relevant issue as long as the policies are chosen through the political process - i.e. when the citizens are voters
- In the framework we consider majority voting with voter preferences that are associated with the financial wealth distribution
- In general, the median voter's preferences and, consequently, the features of his or her financial portfolio will determine the actual overall equilibrium

# Then: Voting on Monetary Policy we can have …

- In general the monetization level chosen by the majority of voters will be:

$$\hat{\delta} = \delta^* - \frac{b^{m\delta}}{\beta}\frac{i}{\varphi}$$

- Therefore it is possible that:

$$\left| \hat{\delta} - \delta^* \right|$$

- And then …

## … Political Pressure

- The more the politicians in charge accommodate the demand for a level of monetization $\hat{\delta}$ that differs from the socially optimal level $\delta^*$, the more a political pressure will be likely to be in action

| | Small Depositor | Normal Depositor | Large Depositor |
|---|---|---|---|
| Large Bondholder | Conservative banking policy<br>Conservative MP | Efficient banking policy<br><br>Conservative MP | Financial dominance<br>Either conservative CBI or fiscal dominance |
| Normal Bondholder | Conservative banking policy<br>Conservative MP | Efficient banking policy<br><br>Efficient MP | Financial dominance<br>Fiscal dominance |
| Small Bondholder | Conservative banking policy<br>Either conservative MP or fiscal dominance | Efficient banking policy<br>Fiscal dominance | Financial dominance<br>Fiscal dominance |

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# The Populist Pressure

- Under which conditions a populist policy can occur?
- We  define as populist any policy that guarantees short-term protection, without regard for long-term fiscal or monetary distortions
- i.e. a policy which is at the same time redistributive and myopic
- Note: In Guzzo and Velasco  (1999) and Lippi (2002)  a populistic monetary policy is just myopic.
- Then, we can identify  a populist policy …

# Populistic Monetary Policy

- An inefficient populist policy $\delta > \hat{\delta}^*$ arises when the majority of citizens are unsophisticated investors – more deposits, less bond - who are on top indifferent with respect to the risk of monetary instability

| | Small Depositor | Normal Depositor | Large Depositor |
|---|---|---|---|
| Large Bondholder | Conservative banking policy<br>Conservative MP | Efficient banking policy<br><br>Conservative MP | Financial dominance<br>Either conservative CBI or fiscal dominance |
| Normal Bondholder | Conservative banking policy<br>Conservative MP | Efficient banking policy<br><br>Efficient MP | Financial dominance<br>Fiscal dominance |
| Small Bondholder | Conservative banking policy<br>Either conservative MP or fiscal dominance | Efficient banking policy<br>Fiscal dominance | Financial dominance<br>Fiscal dominance |

# Populism and Central Banking

- Therefore the populist policy will promote a more accommodative monetary policy, challenging the existing CBI

- In general it is worth noting that:
- This outcome endogenously produces the other definition of populist,
- i.e. that identify as populist a politician who seeks to remove the checks and balances generally applied in a democratic state – as the CBI - in order to fulfil promises made during the election campaign

# Conclusion (1/3)

- We showed that in a country with heterogeneous citizens a macro shock can produce monetary policy preferences which are different from the optimal ones, which are implemented when the central bank is a LT player.
- In such an environment, populist politicians who champion short-term protection policies in favour of a majority of unsophisticated voters can find consensus for a more accommodative monetary policy
- Challenging the existing level of CBI

# Conclusion (2/3)

- Further steps:
- Empirical Analysis: Financial Features, Political Preferences and Policy Choices
- Political Pressure and de facto CBI: Promising metrics but to be handled with care (Type I and Type II error risks)
- Rationale: if the ICB is a long run (LT) player: if $\left|\delta - \hat{\delta}^{*}\right|$ then the Govn't is a SR (SR) player
- But ..

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# Conclusion (3/3)

- But ..
- Type I error: false positive, when $\left|\hat{\delta} - \delta^*\right|$ but the CB is a SR player and the Govn't is a LT player or a SR player with different preferences
- Type II error: false negative $\hat{\delta} = \delta^*$ but both the actors are ST actors with equal preferences

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# Thanks for your attention!




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