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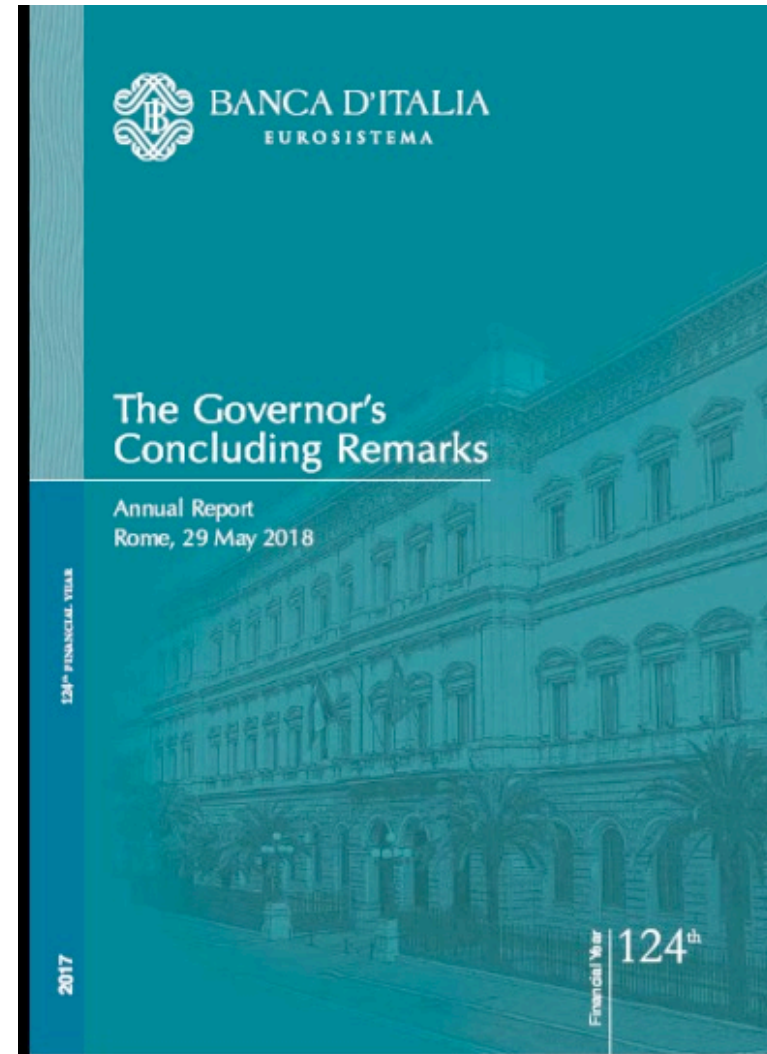
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Bocconi University

May 2018

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

BANCA D'ITALIA
EUROSISTEMA

The Governor's
Concluding Remarks

Annual Report
Rome, 29 May 2018

124ᵗʰ FINANCIAL YEAR

2017

Financial Year 124ᵗʰ

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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

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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
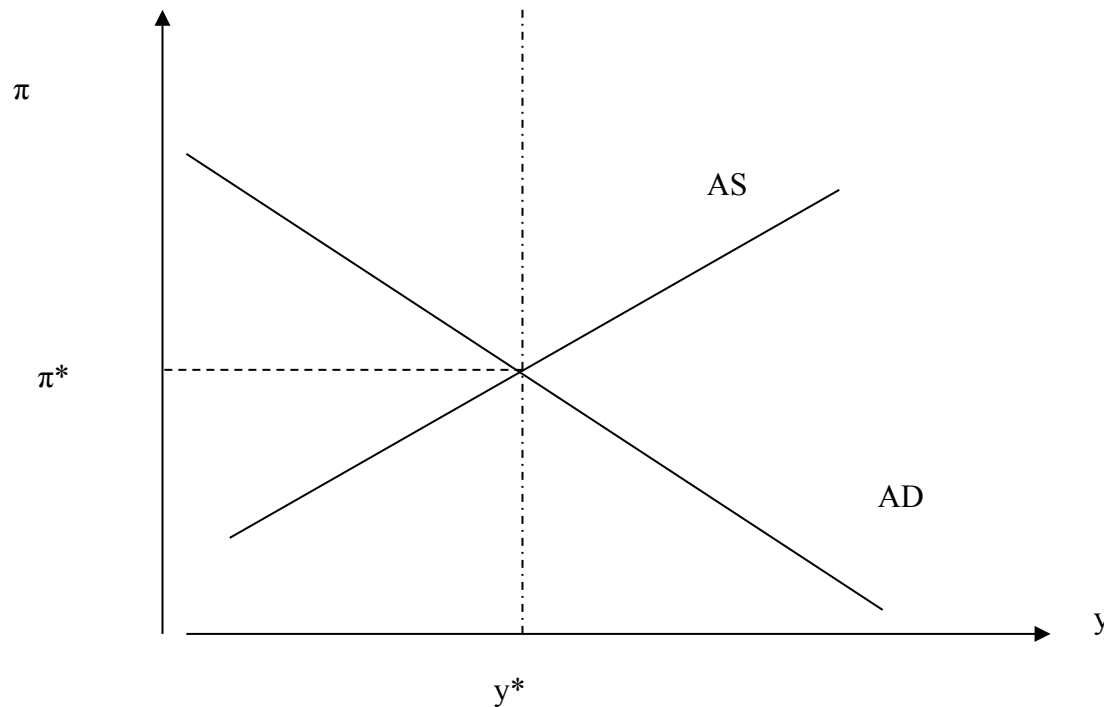
❑ 3) Monetary Policy Actor: Independent Central Bank

Monetary Policy: Goal and Tool. Being in Equilibrium and Without Shocks…

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

$$y = y^*$$

$$\pi = \pi^*$$

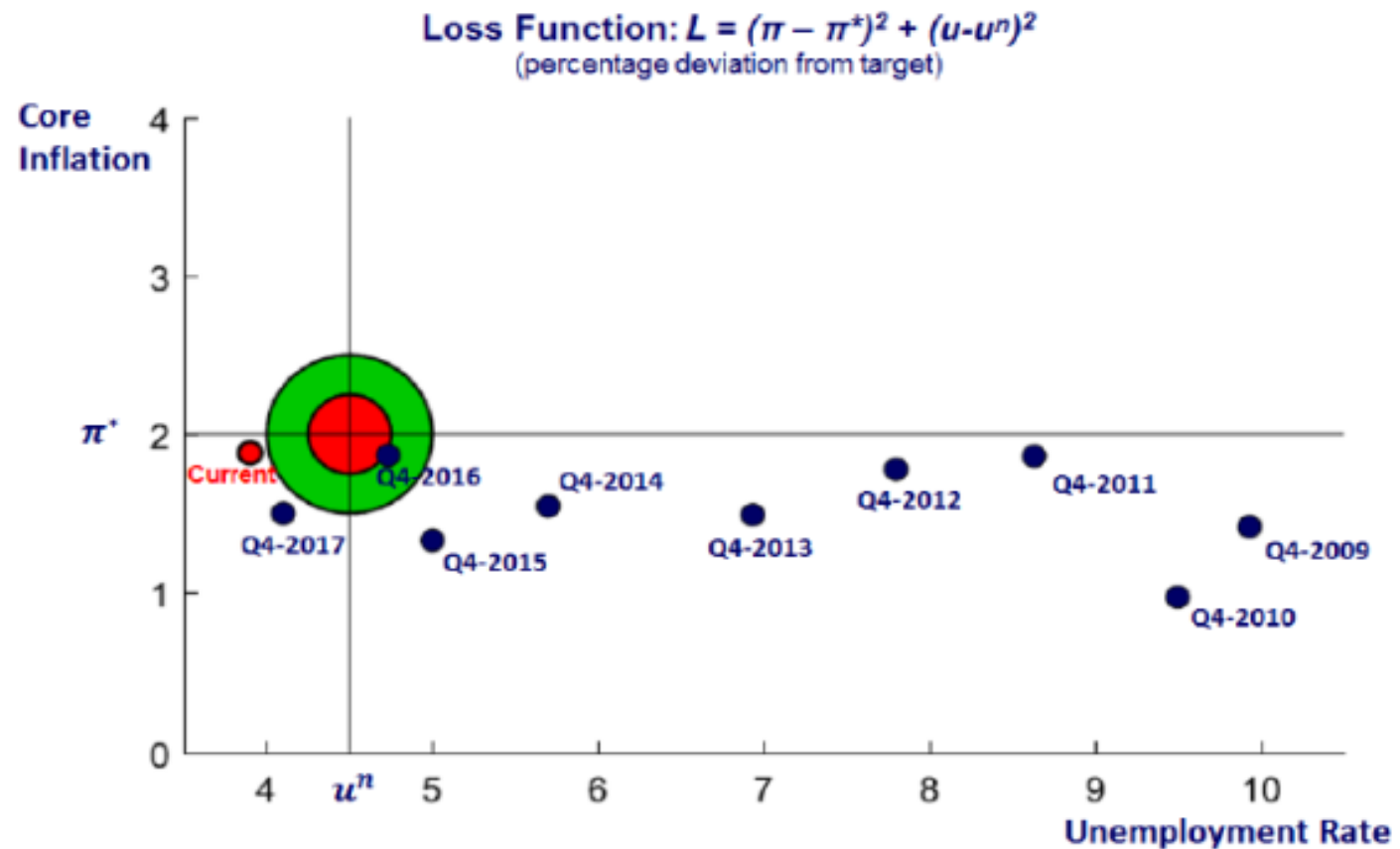$$r = r\hat{}$$

Monetary Policy: … and with Shocks

❑ But Macro Shocks can occur, and the Central Bank have to react …

The Fed's Dual Mandate

Loss Function: $L = (\pi - \pi^*)^2 + (u - u^n)^2$
(percentage deviation from target)

Core Inflation

Current

Q4-2016 Q4-2014 Q4-2012 Q4-2011

Q4-2017 Q4-2015 Q4-2013 Q4-2009

Q4-2010

u^n

Unemployment Rate

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Monetary Policy: Goal + Tool = The Taylor Rule

$$\hat{i}_T = r + \pi + \alpha(\pi - \pi^*) + \beta(y - y^*)$$

- … Using a monetary rule = anchor for agent expectations and behaviour
- With its more common specification, i.e.
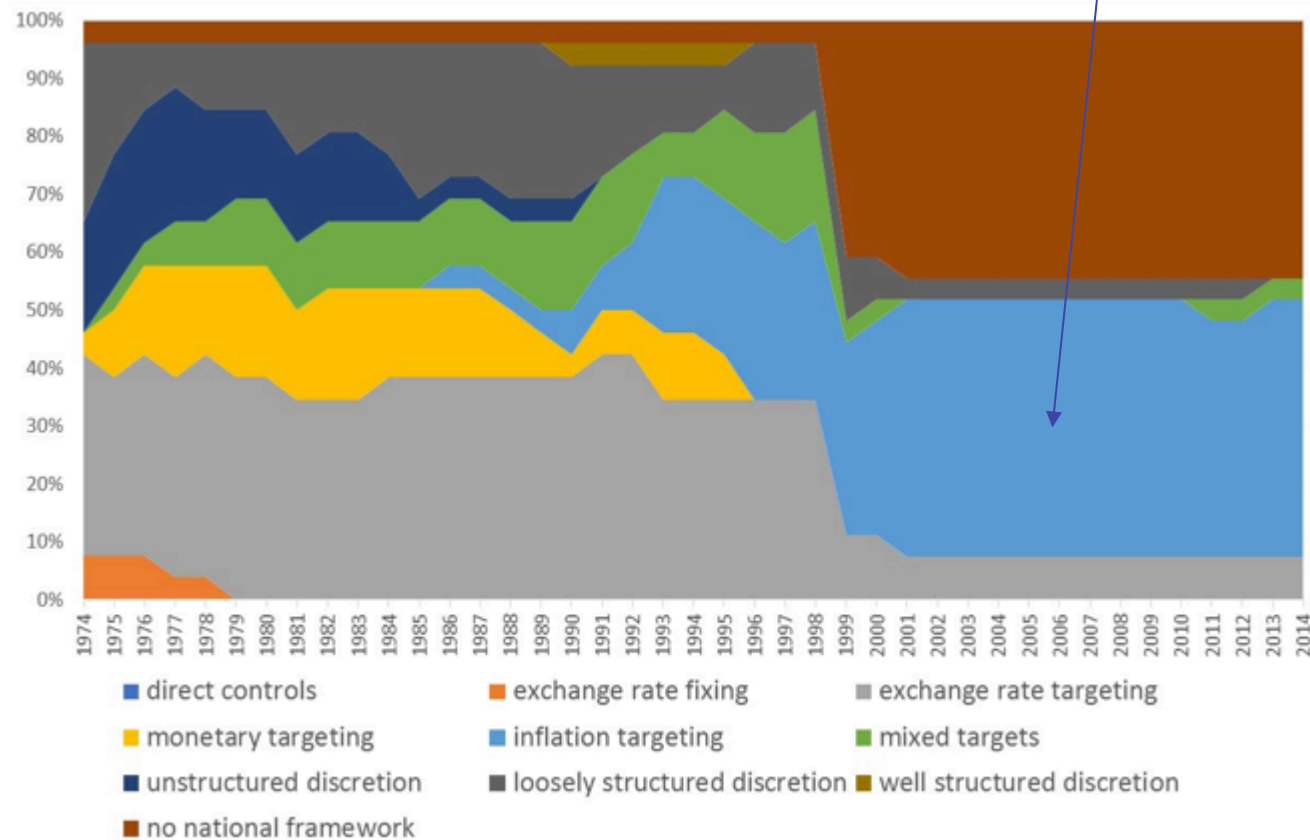- with r^=π*=y* =2 (historical data)
- and α=β=0.5 :

$$i_T = 1.5\pi + 0.5y$$

- That stresses the dominant role of monetary stability
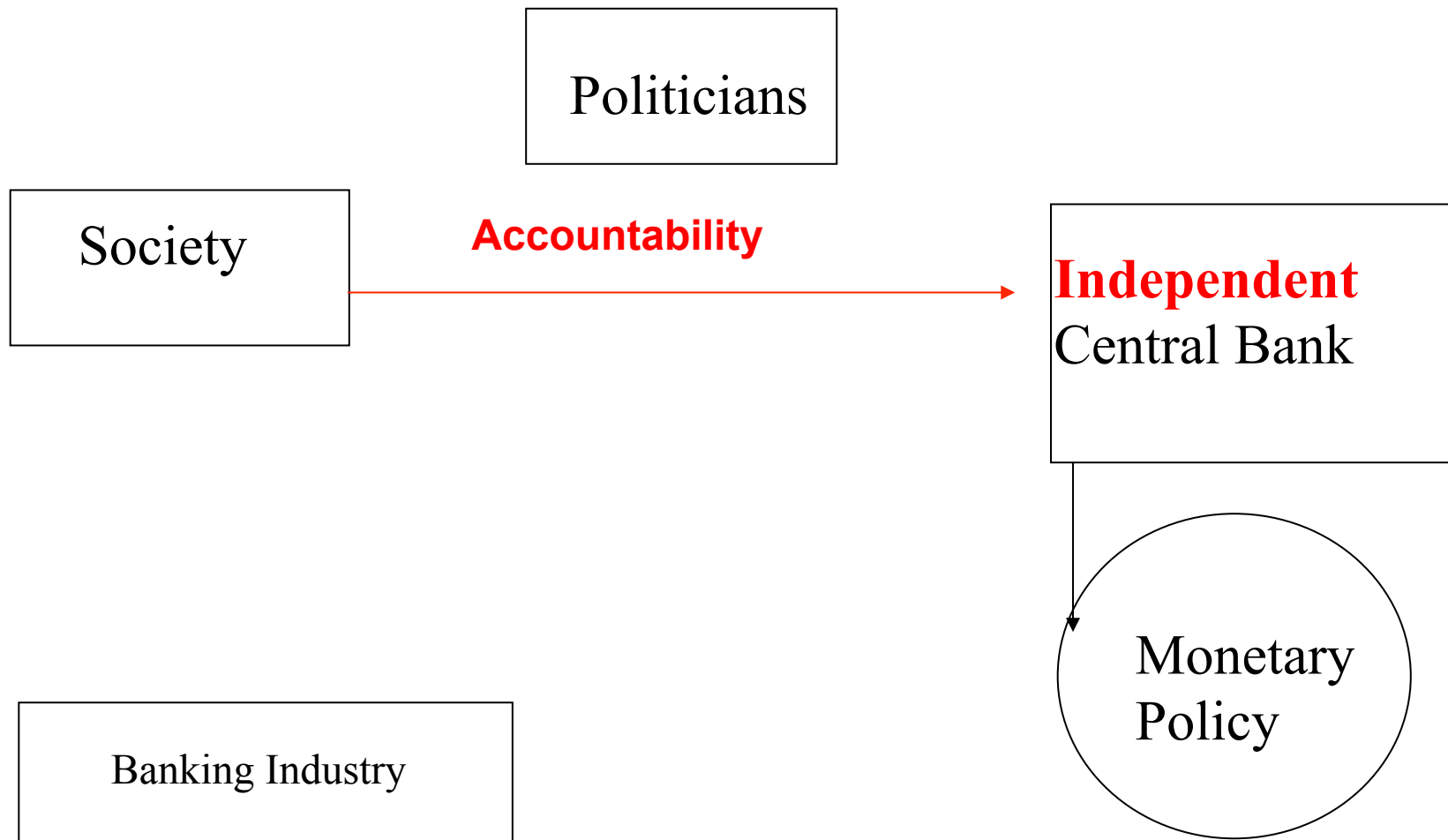
- In fact …

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Monetary Policy and Monetary Stability: The Best Practices

Figure 1 National MPs: Aggregation by target variable, advanced countries

The Monetary Actor: Before the Crisis

Politicians

Society

Accountability

Independent Central Bank

Monetary Policy

Banking Industry

Central Bank: Why Independent? Rationale …

❑ 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

❑ But …

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
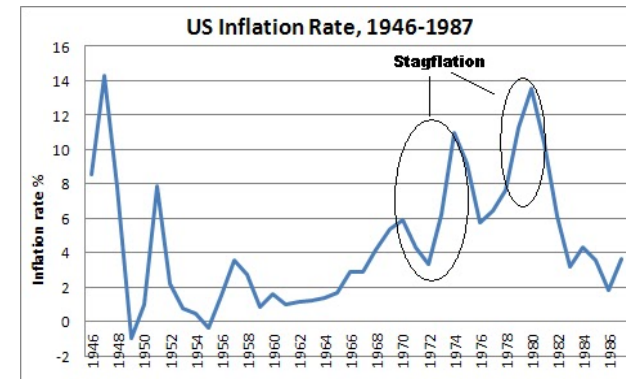Imbalances, Bank Bailout
Imbalances

❑ Solution …

US Inflation Rate, 1946-1987

Figure 2: Money, inflation, the public deficit and Treasury financing in Italy
(percentage points)
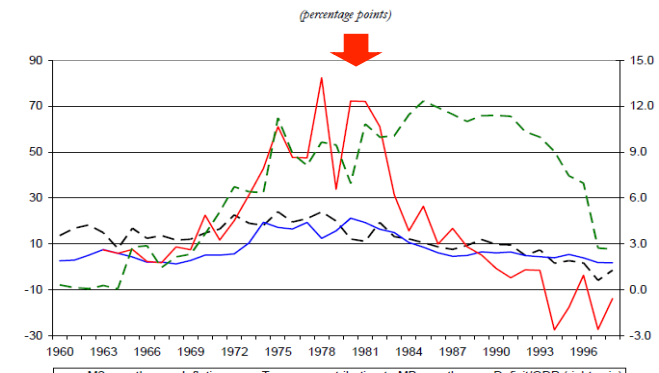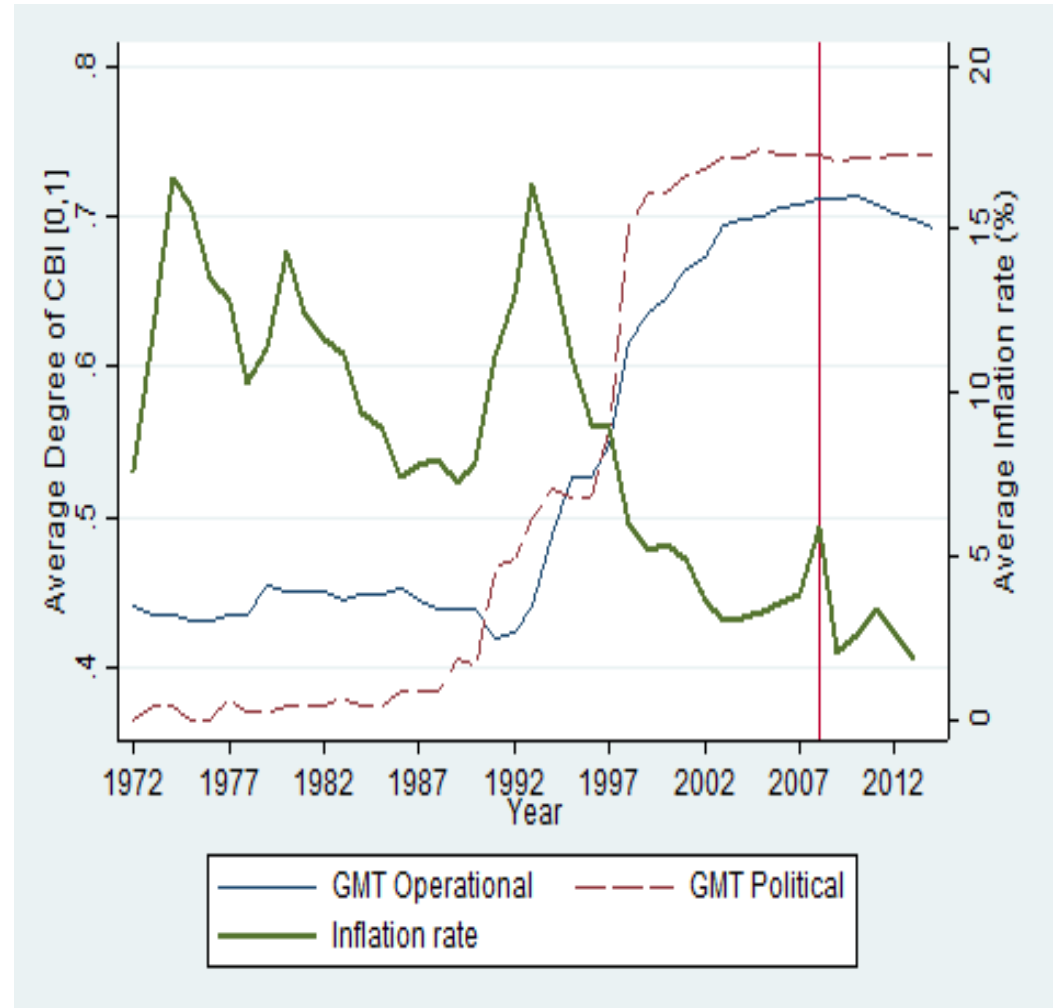

Figure 8. Banking Crises and Central Bank Money

Central bank claims on banks. % increase (after/before t +/- 12)
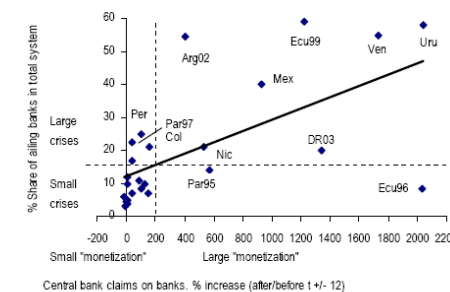
Central Bank: Why Independent? … and Robustness

- ❏ CBI and Macro Performances:

- ❏ Nominal variables: YES

- ❏ Real variables = ?

- ❏ Fiscal variables = ?

- ❏ CBI as a free lunch

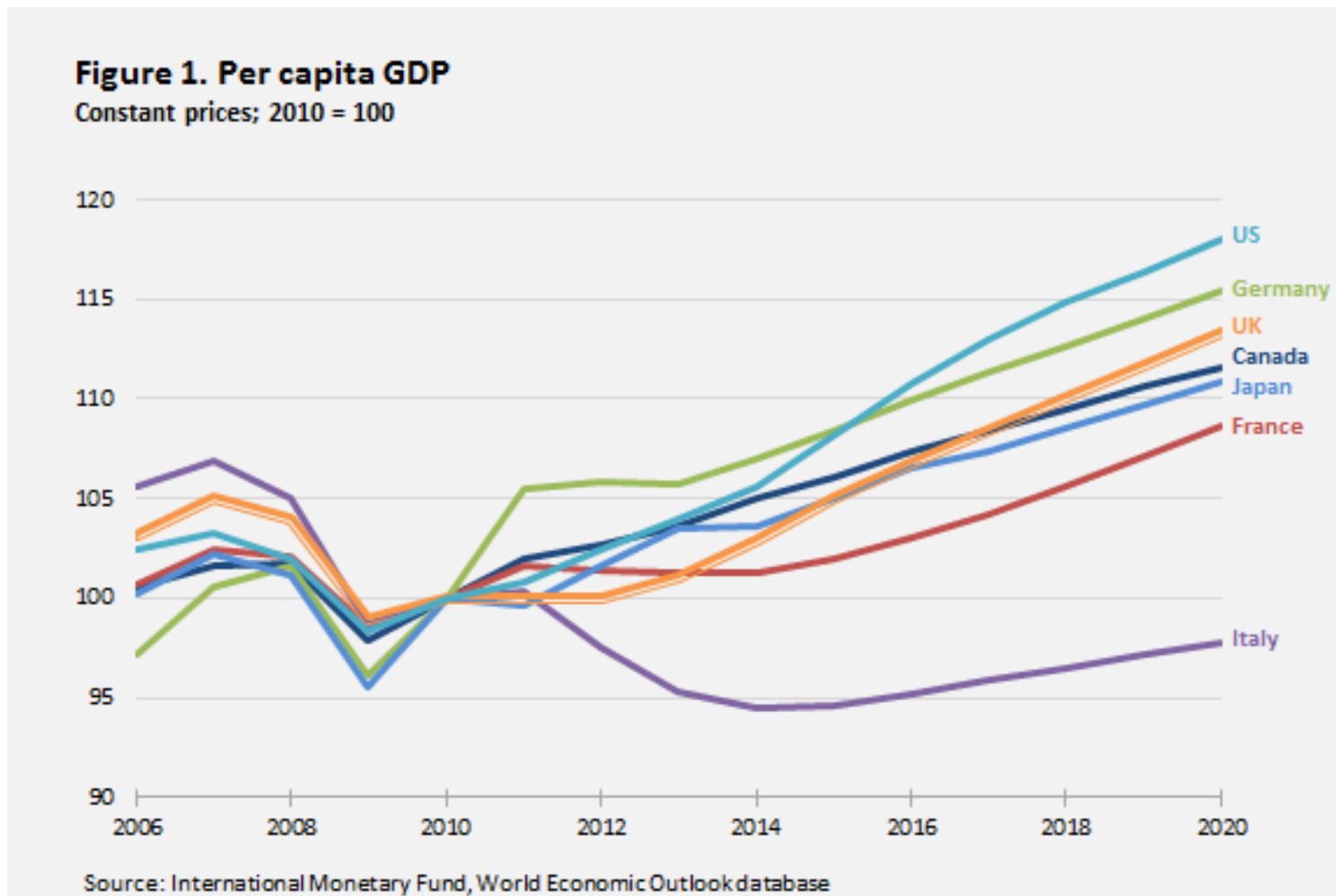Legend: GMT Operational — GMT Political — — — Inflation rate

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

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The Great Crisis

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

Source: International Monetary Fund, World Economic Outlook database

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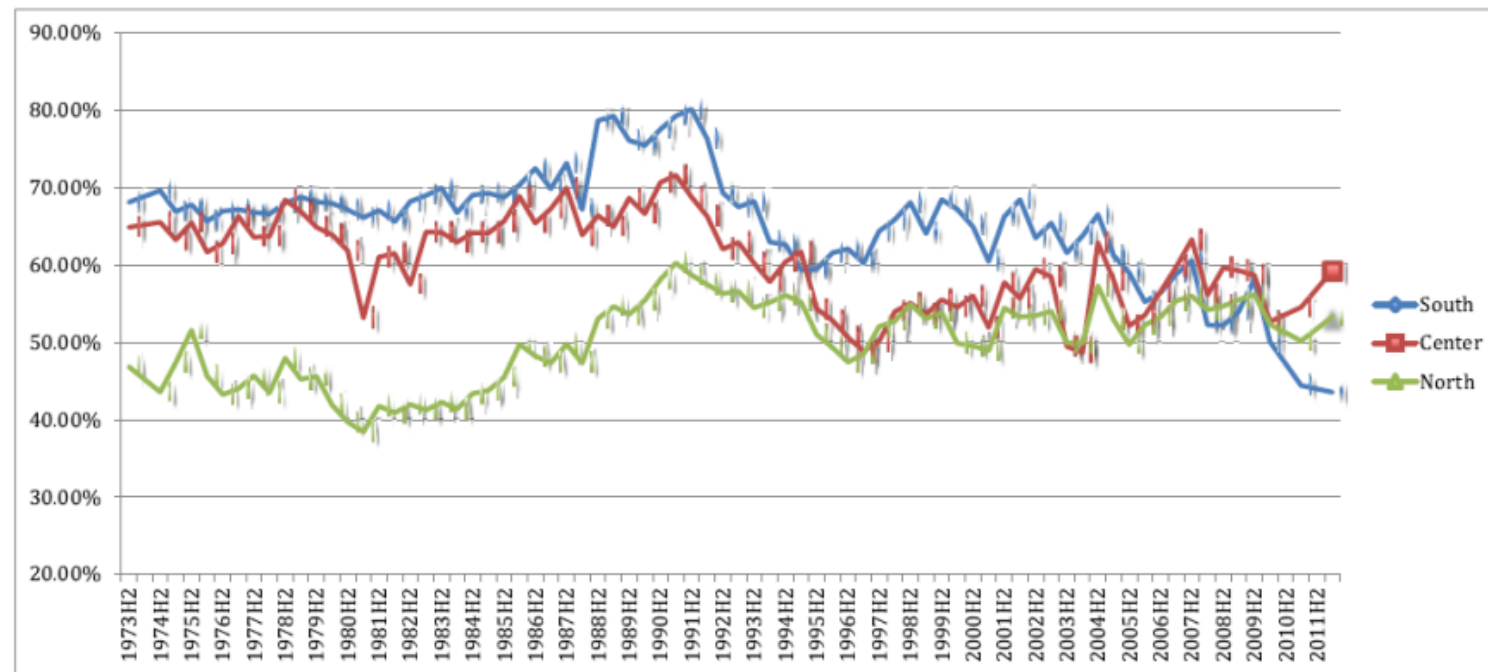# After the Crisis: Sentiments, Monetary Policy and Central Banking

- 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:H2 to 2012:H1.

Panel A

Source: Guiso, Sapienza, Zingales, Monnet's Error?, 2015

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Europhilia and ECB Monetary Policy

**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 definition see Appendix.
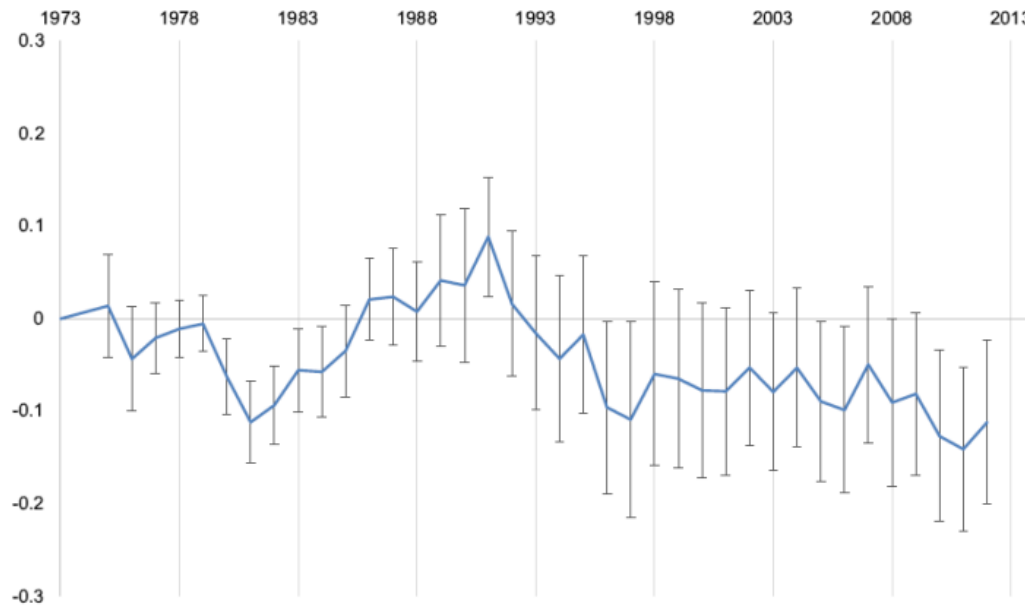
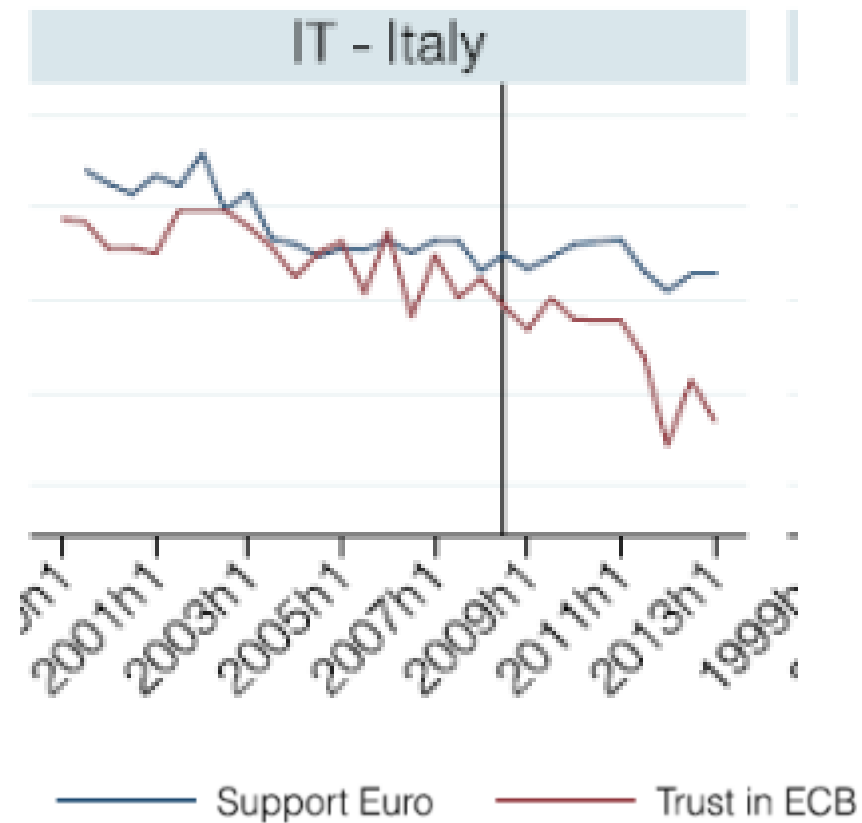# Note: Data on Sentiment & MP - Handle with Care

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

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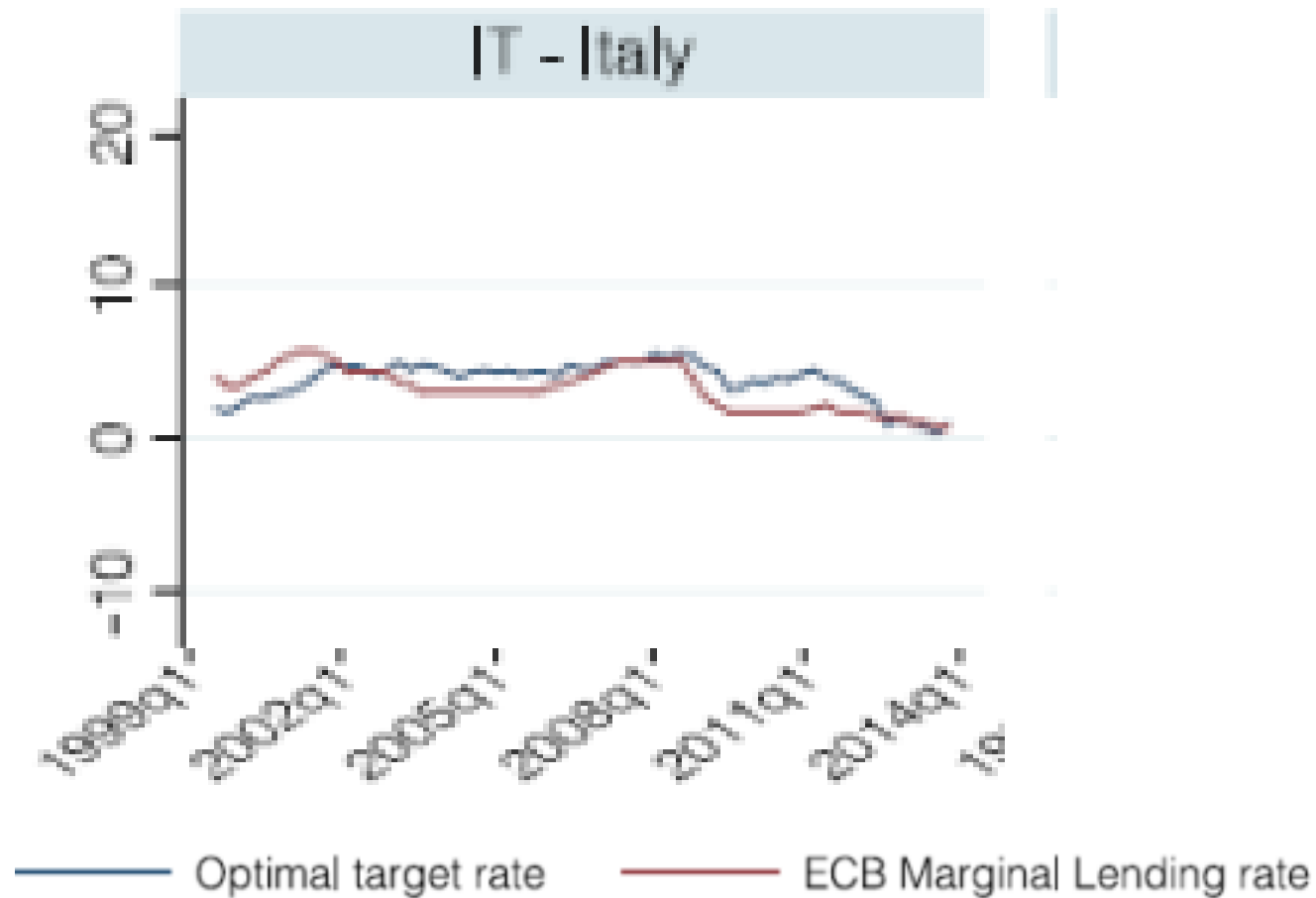Luigi Bocconi
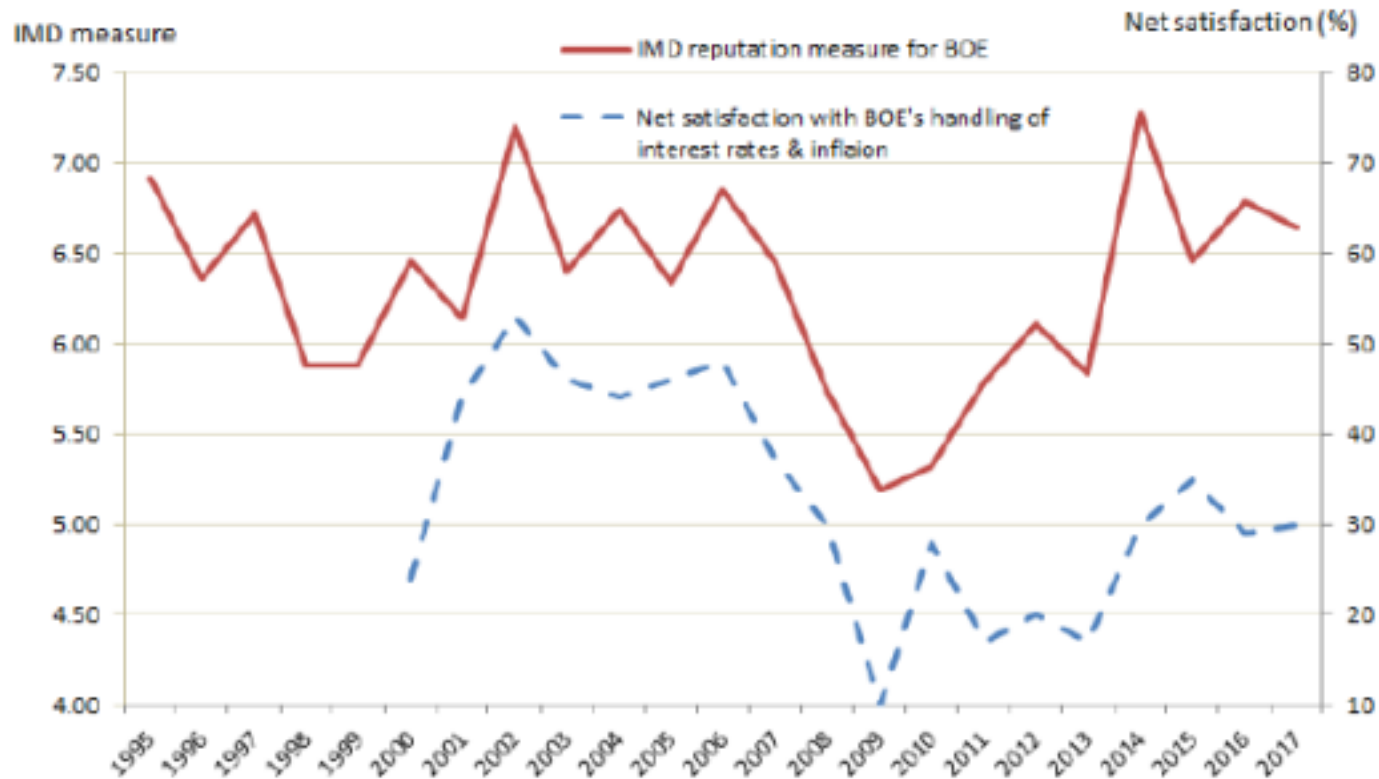
Europhilia and ECB Monetary Policy

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)

IT – Italy

— Optimal target rate   — ECB Marginal Lending rate

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

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ECB and Populism

- On the ECB rules :
- « Asphyxiating rules (...) written by the Bundesbank»
-   Yanis Varoufakis,
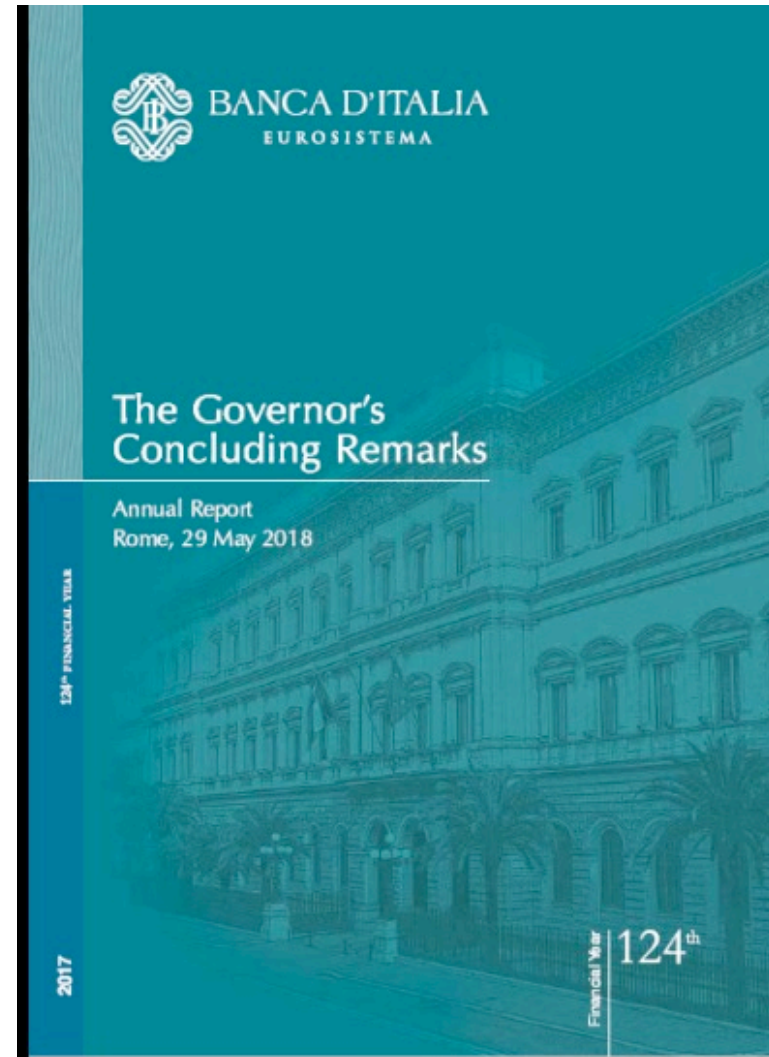
Greece Finance

Minister, Conference

 Press, March 2015

Sentiments and Central Bankers

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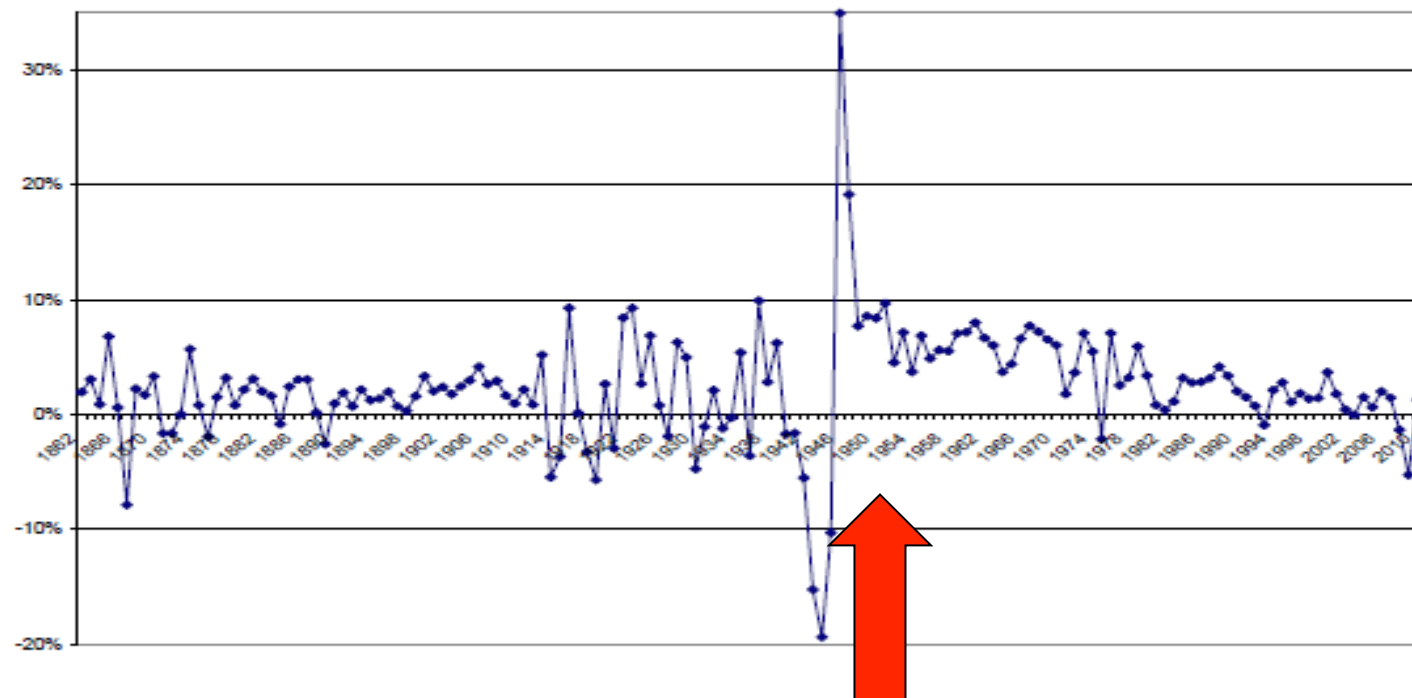# Euro and Italian Macro Performances: The Bank of Italy Arithmetic

❑ 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

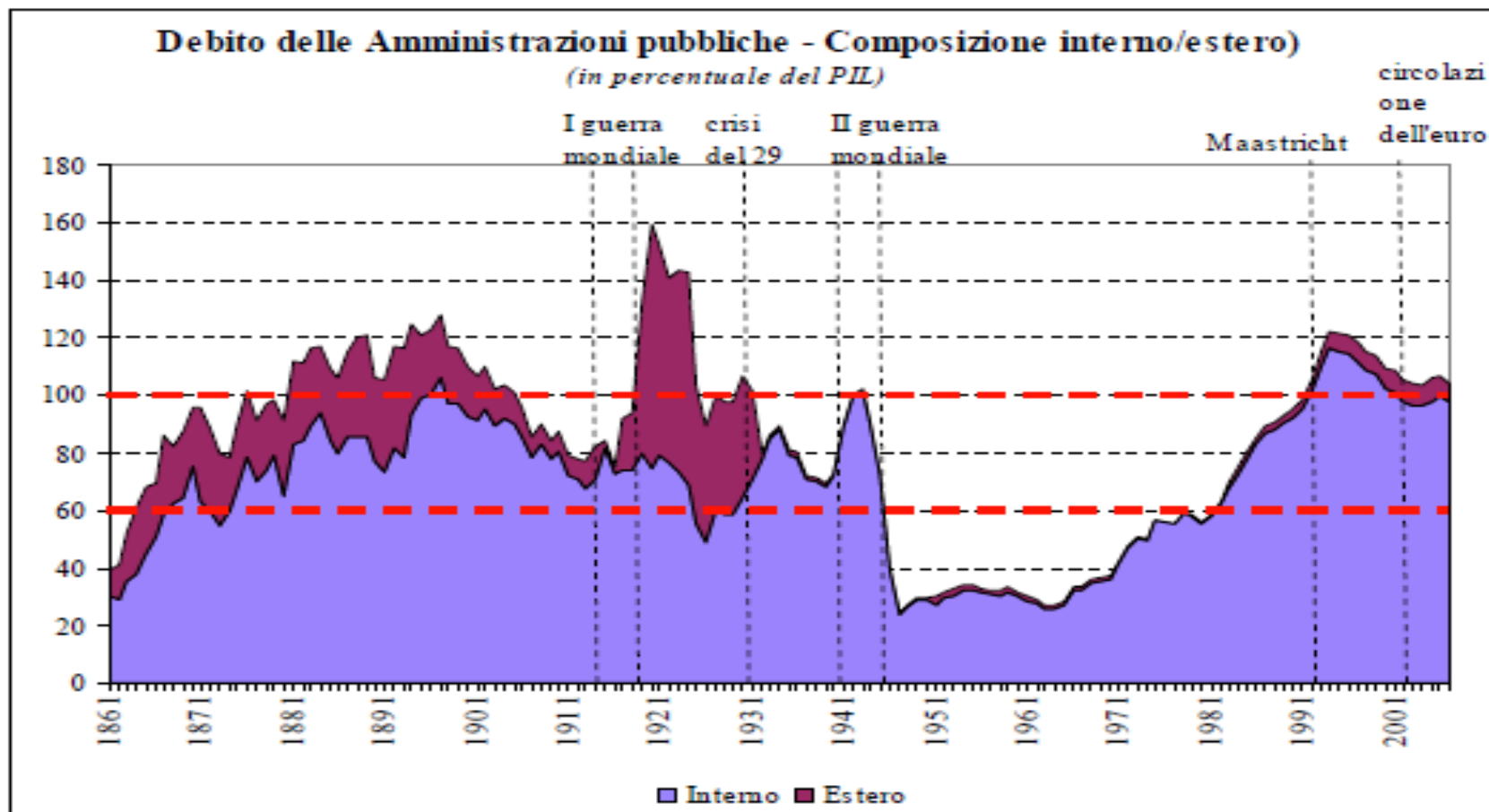### Fig. 3

GDP at constant prices (rates of change)
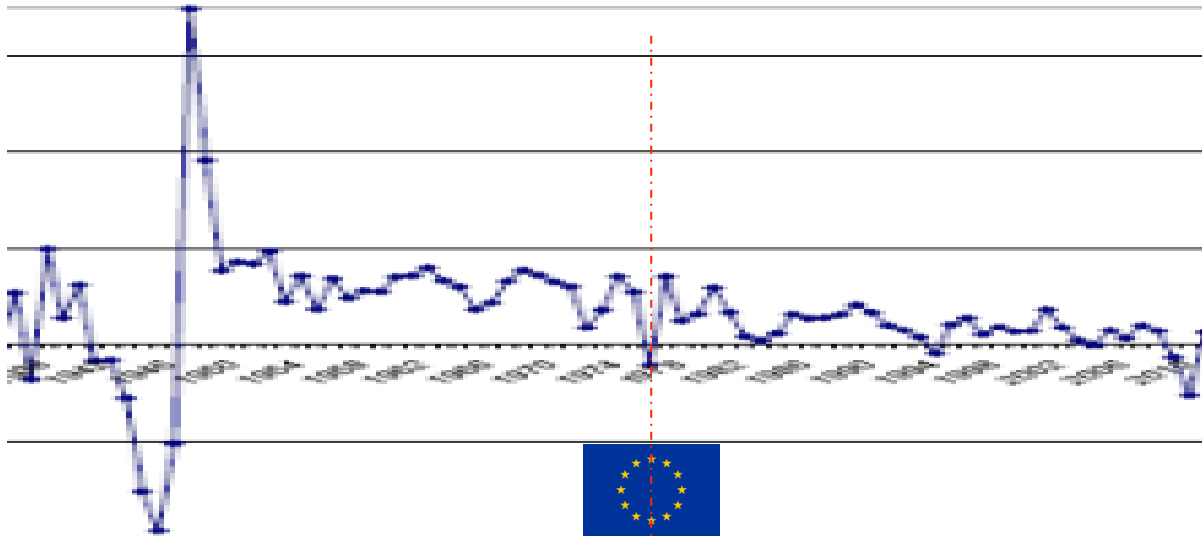
Note: This figure is described on page 11

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Memo: Euro and Italian Macro Performances

Figura 5

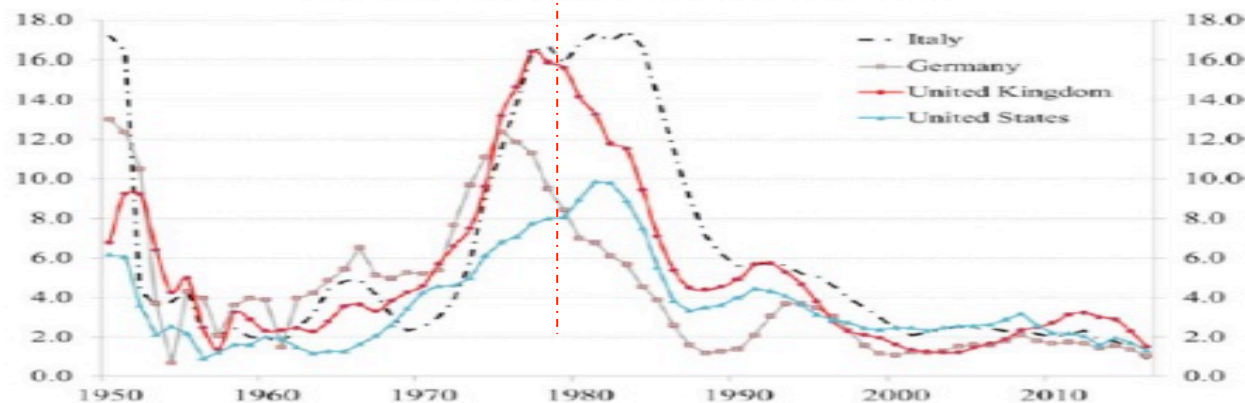Debito delle Amministrazioni pubbliche - Composizione interno/estero)
(in percentuale del PIL)

Memo: Euro and Italian Macro Performances

1979 = ERM=
European Exchange
Rate Mechanism

Figure 1: Inflation, 1946 – present

- · Italy
- Germany
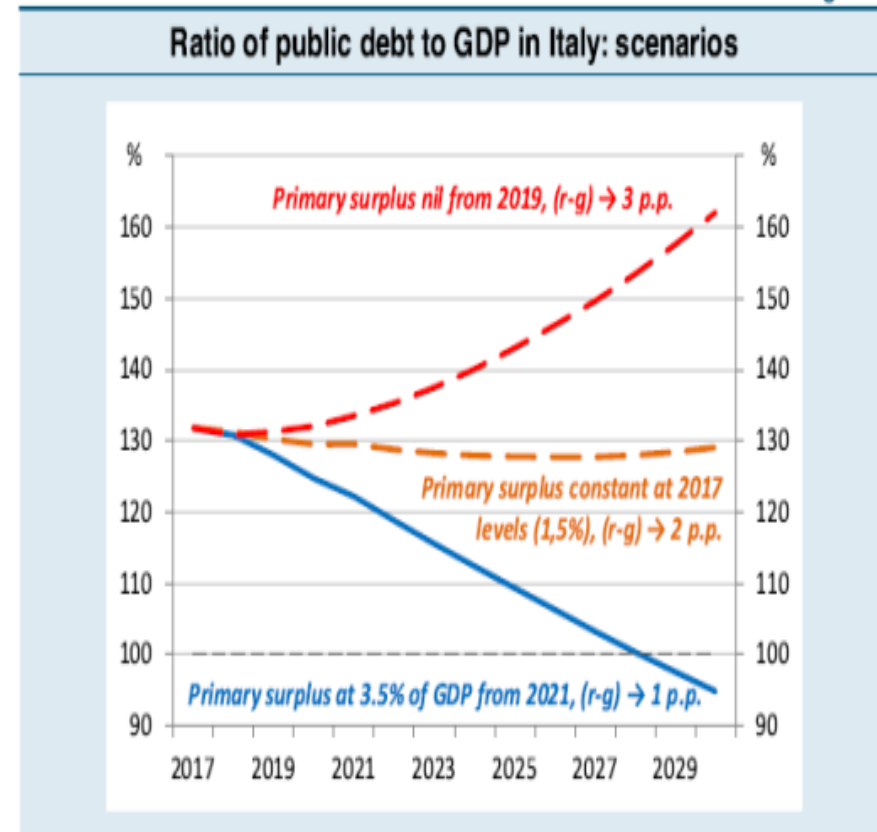- United Kingdom
- United States

Annual growth rates of the consumer price index, 5-year moving averages.
Source: C. Reinhart and K. S. Rogoff, 'From Financial Crash to Debt Crisis', NBER Working Paper,
15795.

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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

Primary surplus nil from 2019, (r-g) → 3 p.p.

Primary surplus constant at 2017 levels (1,5%), (r-g) → 2 p.p.

Primary surplus at 3.5% of GDP from 2021, (r-g) → 1 p.p.

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