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Conventional and unconventional monetary policy vs. households income distribution: An empirical analysis for the Euro Area

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ABSTRACT

By recovering measures of income dispersion from the European Commission Consumer Survey, this analysis addresses whether conventional and unconventional monetary policies affect income inequalities in the Euro Area and the impact thereof on monetary transmission. First, in a VAR framework, the effects of both types of monetary policy on income distribution are evaluated. Second, the marginal effect of income dispersion on the consumption elasticity to monetary shocks is investigated using the same framework. The results suggest high cross-country heterogeneity in the impact of monetary policy and non-linearities associated with the redistributive strength of fiscal policy and the maturity of the household portfolio. Standard expansionary monetary measures typically have a small contractionary effect on income distribution. Mildly high-income dispersion is beneficial for the transmission of the monetary shocks to consumption because it overcomes the negative effect of consumption smoothing. However, for what concerns Q.E. measures, poorly redistributive fiscal policy and highly sensitive households' portfolio might trigger these results.

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1. Introduction

<<. .in the short-term, are the financial effects of monetary policy creating regressive or unwelcome distributional effects in the Euro Area and in individual countries? And over the medium-term, how is that being offset by the macroeconomic effects of our measures?>>. Mario Draghi, president of the ECB, 2nd DIW Europe Lecture, Berlin, 25 October 2016.

Recently, the interaction between monetary policy and the dispersion of income and wealth distributions have been largely discussed. The potential dis-equalizing impact of an expansionary monetary policy in the Euro Area (EA) has caught the attention of the public and policy-makers, including the Board Members of the European Central Bank (ECB), also on account of the recent prolonged period of low interest rates and the ongoing implementation of unconventional monetary policy (UMP) measures, like the LTRO (Long Term Refinancing Operation) and the APP (Expanded Asset Purchasing Program).

Although virtually all kinds of economic policy measures have some distributional impact, when it comes to monetary policy, distributional considerations have been largely overlooked. Several central banks, including the ECB, have as a first objective to maintain price stability over the medium term, but, especially during financial and economic crisis or in

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prolonged period of zero-lower bound constraints, there are some technical, non-judgmental interests for central bankers in the distribution of income and wealth (for example the negative direct effect on consumption, long term growth, etc.) that have made them questioning about how long the distributional side-effects should be tolerated.

Historically, income and wealth dispersions in the EA have been low and the largely redistributive fiscal policies have contributed to contain their growth, as argued by Domanski et al. (2016). This analysis find that redistributive fiscal policy reduced the level of wealth and income inequality in most of OECD advanced economies, although it did not change the long-term trends. However, since 2009, the Long-Term Refinancing Operations (LTRO, TLTRO, etc.) and the several Asset Purchasing Programs (CBPP3, ABSPP, PSPP, CSPP, etc.) have made the public to worry about distributive consequences of these programs and they have increased the attention on inequalities. Already in 2012, the Bank of England, pressed by the Government, has made some effort in evaluating the effects on inequality of the unconventional monetary policies implemented in the U.K.¹

The research proposed here assesses the impact of both conventional and unconventional monetary policy in the EA, aiming to disentangle the puzzle of the monetary policy (conventional and unconventional) distributional consequences and to provide policy prescriptions about how much the ECB should care about this type of side effects, and broadly, about income and wealth inequalities.

The first reason behind such new worldwide interest on the distributional effects of monetary policy is the increasing criticism from the public towards the independence of the central banks. This perceived democratic deficit is often accompanied by the feeling that central banks, although nowadays largely independent from the central governments, are not fully independent from the management of large companies, especially, large national banks. For instance, in an extensively debated article appeared on the New York Time in 2012, Daron Acemoglu and Simon Johnson accused the Fed to “. . . have given way completely and with disastrous consequences, when the bankers bring their influence to bear. . .”²

Additional and, perhaps, more relevant motivations behind such an increasing interest are represented by the potential damaging effects of high income inequalities on both economic growth and financial stability, which, in turn, might trigger the benefits of an expansionary monetary policy on the economic growth. Among the others, the following contributions point out the major issues:

- Ostry et al. (2014) by using a large panel dataset, in which they separate the measures of net inequalities from the redistribution policy ones, prove that lower net inequality is robustly correlated with faster and more durable growth, for a given level of redistribution, and that the direct effect of redistribution by fiscal policy might be negative. Indeed, high inequality leads to more fragile economic growth due to investment- reducing political and economic instability, lower social consensus and less progress in health and education.
- Ko (2015), Motta and Tirelli (2014) and Areosa and Areosa (2016) in New-Keynesian DSGE models with segmented labor market and limited assets participation show that when a Central Bank overlooks heterogeneity in labor market, and thus inequality in labor income, its (optimal) monetary policy causes significant higher welfare losses than when inequalities are taken into account. Since high income inequality enhances the stickiness of aggregate wage adjustments and leads to greater fluctuations of output and employment, the consequent less-accommodative monetary policy would not stimulate enough the demand of labor, ultimately leading to an increase in low-skilled and high-skilled workers' unemployment and, hence, to declining consumption for both types of households.
- Rajan (2010) and Turner (2015) posit that respectively in the U.S. and in the U.K., due to the growing inequalities in income distribution, the benefits of rising aggregate income over the past decades where confined to a rather small group of households at the top of the income distribution. Although consumption does not vary much along the income distribution due to the permanent income theory, the consumption of the lower and middle-income groups was largely financed through rising credit rather than raising income. Henceforth, credit growth was as much necessary to boost demand as unsustainable.

Although the intense debate on the topic and the growing interest from both the academia and the international institutions, the empirical literature is still scarce and sometimes contradictory. The influential paper of Coibion et al. (2012) reports positive redistributive effects of an expansionary monetary policy in U.S. over the period 1980–2008 because of the asymmetric effect of a change in the policy interest rate on labor earnings along the income distribution, while Davtyan (2016) by considering measures of inequalities inclusive of the top-1% and accounting for the long-run relationships among the variables, challenges this view. Furthermore, the findings in Coibion et al. (2012) have been strongly debated as

¹ <<Loose monetary policy, achieved through Q.E. and low interest rates, has re-distributional effects, particularly penalizing savers, those with 'drawdown pensions' and those retiring now [...] While the aggregate savers and pensioners may receive some benefits from higher assets prices, there will be many individuals who will not have benefited. The BoE should provide its estimate of the overall benefit and loss to pensioners and savers from Q.E. [...] We further recommend that the BoE, and particularly MPC members improve their effort to explain the benefits of the current position of monetary policy to those affected by the redistributive effects of Q.E. [...] >> Treasury Committee for the House of Commons, "2012 budget", Treasury- 30th report, London, April 2012.

² << Monetary policy has an impact on inflation, output and unemployment. But it also has a major impact on stock market prices. Any central banker raising interest rate is id reducing stock market values and thus eroding the bonuses of top bankers and other chief executives [...] In principle, the FED could stand up to the bankers, punishing back against all specious argument. In practice, unfortunately, the New York Fed and the Board of Governors are quite deferential to finance-sector "experts" [...] In the recent decades, the Fed has given way completely, at highest level and with disastrous consequences, when the bankers bring their influence to bear [...] >> Acemoglu D. & S. Johnson "Who Captured the Fed?" New York Times, 29-Mar-2012.

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