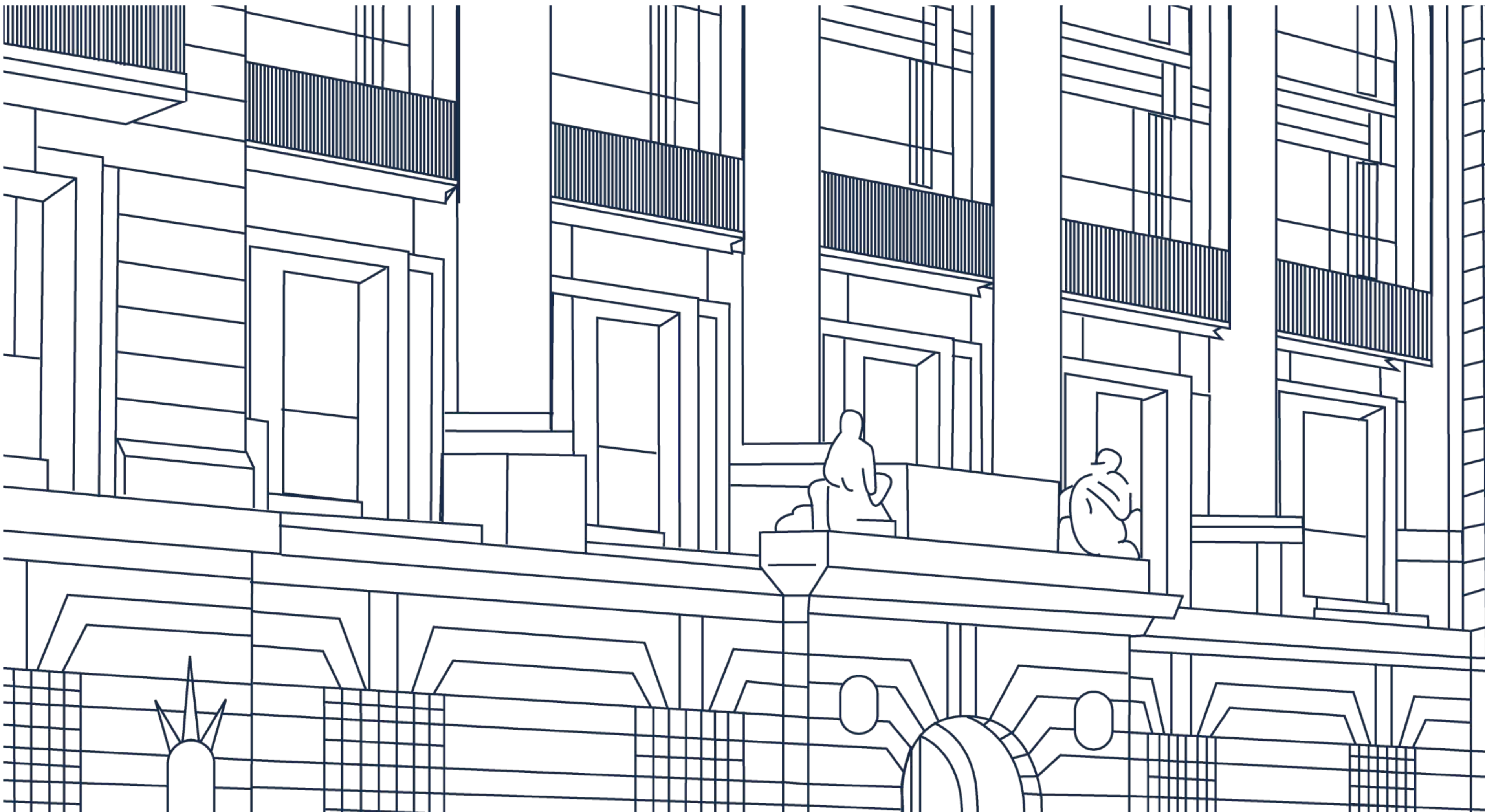

Primary Considerations for an Emerging Market's Central Bank regarding the Distributional Effects of Monetary Policy

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BANCO DE MÉXICO

*The opinions expressed are those of the author and do not necessarily represent those of Banco de México.

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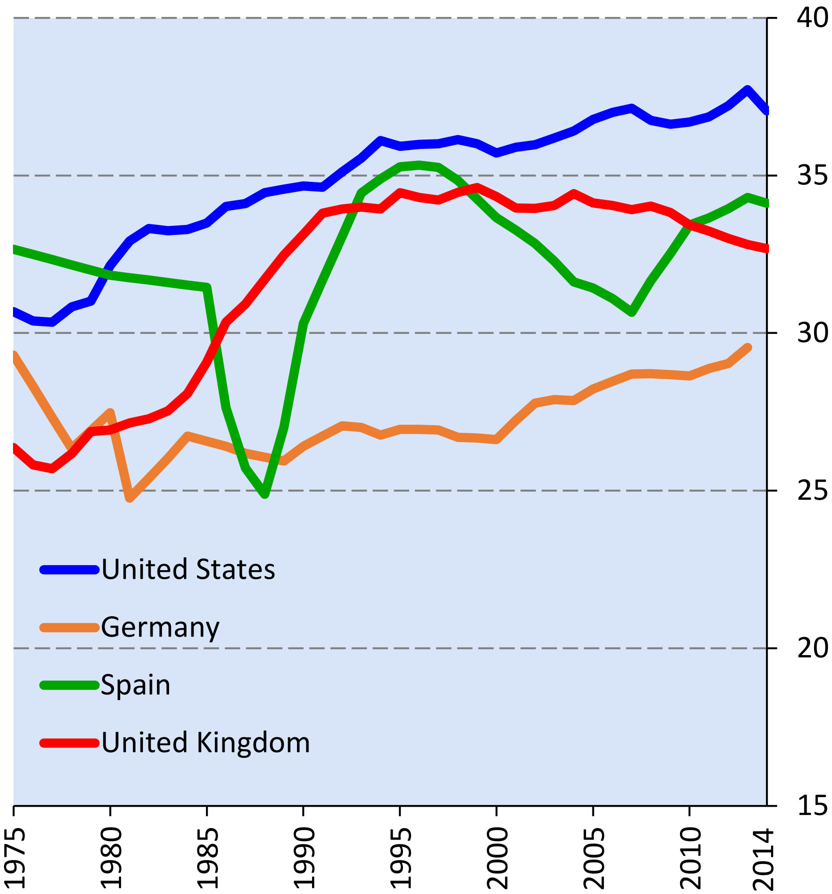
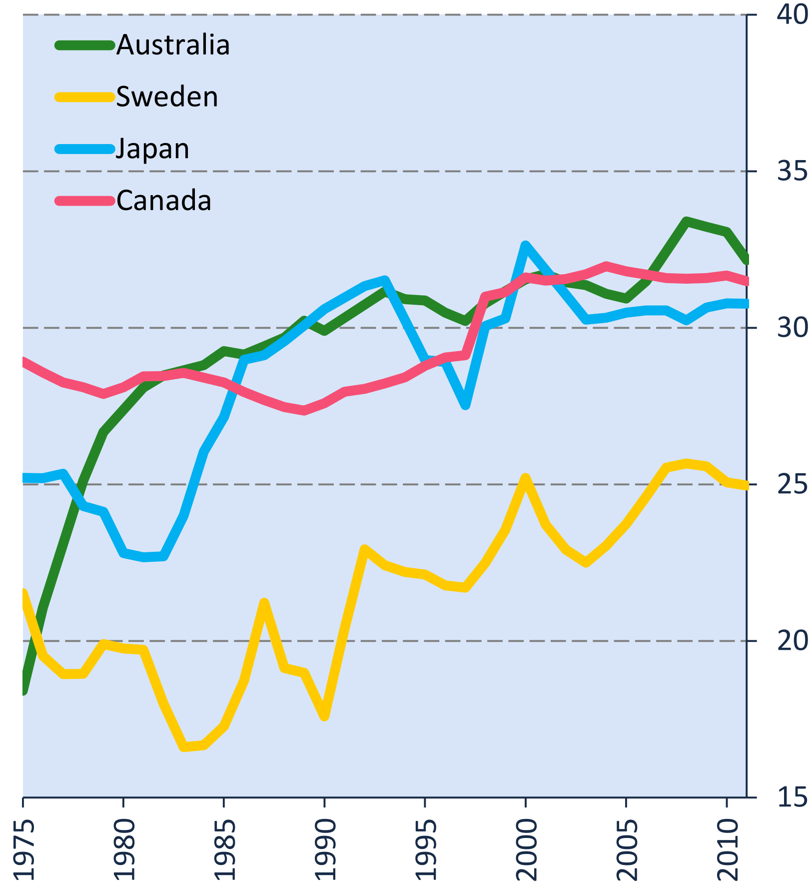
Introduction

- Inequality seems to have increased in advanced economies.

Germany, Spain, UK and U.S.
Gini coefficient in percent*



Australia, Canada, Japan and Sweden
Gini coefficient in percent*



Source: *Banco de México* with data from the Standardized World Income Inequality Database (SWIID) v5.1 (Solt 2016).
*A value of 0% corresponds to complete income equality, 100% to complete income inequality.

Introduction

- There seems to be a **renewed interest** on studying inequality, its causes and consequences.

    - *There are new and more comprehensive data surveys available. For example: the Household Finance and Consumption Survey (HFCS) in Europe.*

    - *Some administrative data is now being exploited. For example, Saez and Zucman (2014) have used tax return data.*

    - *There have been some influential works published. For example, Piketty's (2014) Capital in the 21st century.*

Introduction

- New studies may be suggesting more worrisome scenarios than previously thought regarding inequality in advanced economies.

- Also, there seems to be the belief that inequality could be the cause of some of the political and economic turmoil that we are currently experiencing.

Introduction

- In general, we do not like inequality.

- Governments, researchers and policymakers are looking for the reasons behind the increase in inequality and for possible ways to deal with it.

- As **monetary** policymakers, we are concerned about the following questions:

  1. *Has monetary policy contributed to the rise in inequality?*
  2. *What is the relationship between inequality and the transmission channels of monetary policy?*
  3. *Can monetary policy do anything to reduce inequality? Should it try?*

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❶ Has monetary policy contributed to the rise in inequality?

- It is possible that the introduction of **unconventional monetary policy** in response to the Global Financial Crisis has led to an increased concern that monetary policy has indeed contributed to the rise in inequality.

- QE may have had large and persistent valuation effects on financial assets.
  - *If the "rich" hold relatively more financial assets than the "poor", then unconventional monetary policy, by increasing their price, can lead to more inequality.*
  - *Simulation results by Domanski, Scatigna y Zabai (2016) suggest that in developed economies rising equity prices may have added to wealth inequality, and that this effect may have been only partially offset by a recovery in housing prices.*

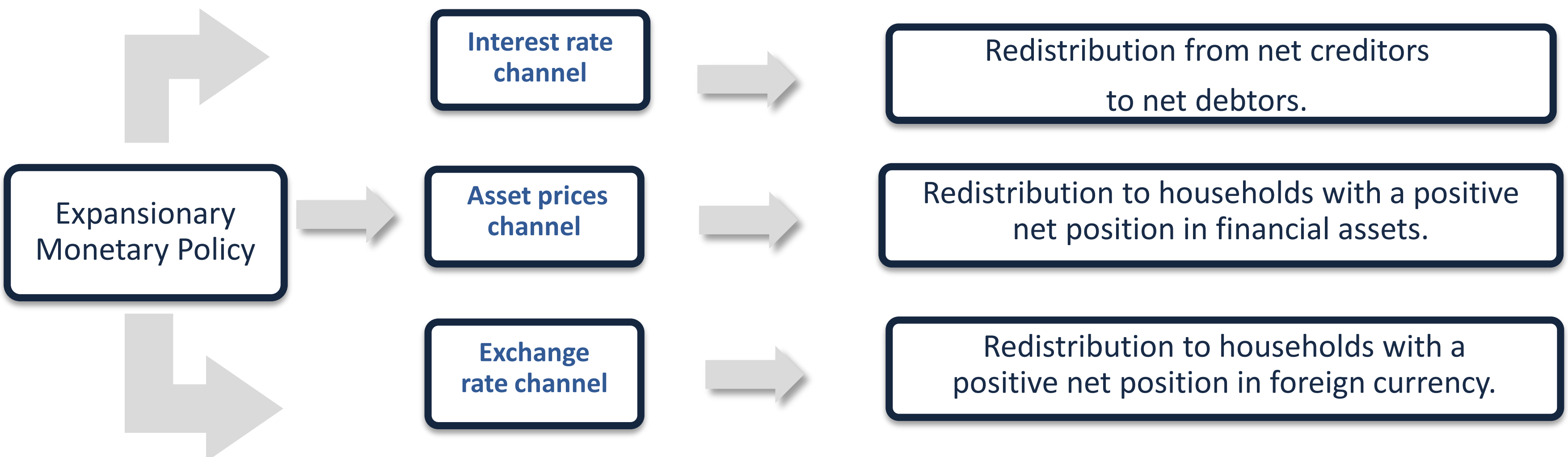
❶ Has monetary policy contributed to the rise in inequality?

- However, it is perhaps **too early to tell**.
  - *Traditional monetary policy theory tells us that distributional effects are not permanent.*
  - *Nine years after the GFC, we are still on the same recovery cycle. Hence, the distributional effects arising from the monetary policy measures pursued after the GFC might yet prove to be temporary.*

- Moreover, even if unconventional monetary policy measures like QE had a negative effect on inequality, one must consider the **counterfactual**:
  - *What would the landscape for inequality be if monetary policy had not reacted to the GFC the way it did?*
  - *According to ECB simulations, euro area GDP would be cumulatively at least 1.5% lower between 2015 and 2018 without the expansionary policy measures adopted since mid-2014, with worse outcomes for inflation too (Draghi, 2016).*

❷ What is the relationship between inequality and the transmission channels of monetary policy?

- Monetary policy affects interest rates and asset prices, which causes a redistribution of wealth and income among households and businesses according to their net financial position.
- **That is, monetary policy works through redistribution. However, in principle, its effects should not be permanent, as it does not have long-term effects on real variables.**



- **Would more inequality make monetary policy more or less effective?**

❸ Can monetary policy do anything to reduce inequality? Should it try?

- Yes! By fulfilling its mandate.

I. ***Central Banks should focus on keeping inflation under control.***

  - *It is well known that inflation has negative effects on poverty and inequality.*
    - Low inflation is associated with an improved well-being of the poor in the long run (Romer and Romer; 1998).
  - *High inflation is costly for the economy and society as a whole.*
    - *It creates uncertainty and discourages investment.*
    - *It disrupts financial markets.*
    - *It may harm some sectors of the economy disproportionately.*

❸ Can monetary policy do anything to reduce inequality? Should it try?

II. ***Ex-post crisis management:*** *By using monetary policy to lessen the overall negative effects of a crisis, it can reduce the adverse effects of lower growth or higher unemployment, among other negative consequences.*

III. ***Ex-ante crisis prevention:*** *By keeping inflation low, Central Banks strengthen the macroeconomic fundamentals of their economies, and thus reduce the probability of an economic crisis happening at all.*

❸ Can monetary policy do anything to reduce inequality? Should it try?

- There does not seem to be enough support to argue that Central Banks should have an explicit mandate to reduce inequality, but they can still contribute to fighting it.

- Central Banks could try to **be more vocal** about the importance of **supply side reforms** that improve the dynamics of prices:
  - *Reforms aimed at increasing <u>productivity</u> in the economy should be promoted.*
  - *In particular, policies that increase <u>competition</u> may have large effects at improving the welfare of low-income individuals and at reducing inequality through lower prices.*
  - *Central banks have the <u>research</u> capacity to direct resources to show that this channel is important.*

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Primary considerations for an emerging market economy.

- Taking into account:

  I. *The arguments discussed in the previous section.*

  II. *That inequality in Latin America has declined over the last 15 years, contrary to what has been observed in advanced economies, but, like poverty, remains at high levels.*

  III. *That Latin American central banks did not implement unconventional monetary policy during the Global Financial Crisis.*

- I would argue that the primary considerations for an emerging market's central bank regarding the distributional effects of monetary policy should be:

  - *To keep inflation low and stable.*

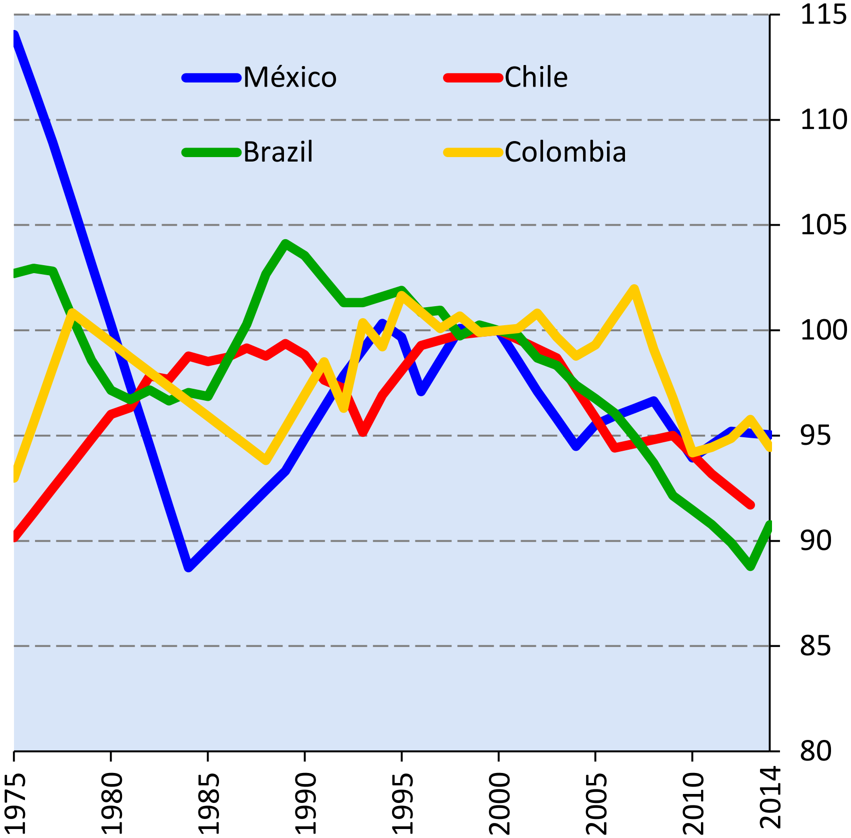
  - *To focus on ex-ante crisis preventions and ex-post crisis management.*

- This seems to be particularly important given the relatively high levels of poverty in emerging markets and the adverse effects of inflation and economic crisis on the poor.

Income Inequality has declined in Latin American countries.

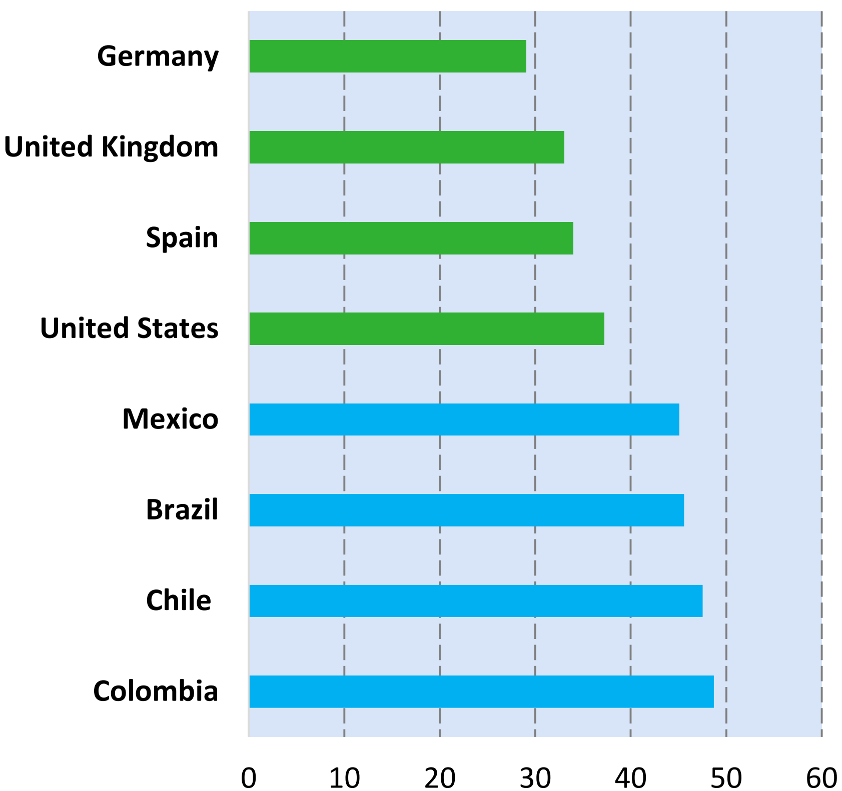
- In contrast to developed countries, income inequality in Latin America has been decreasing, though it remains at high levels.

Brazil, Chile, Colombia and Mexico
Gini coefficient, Index 2000=100



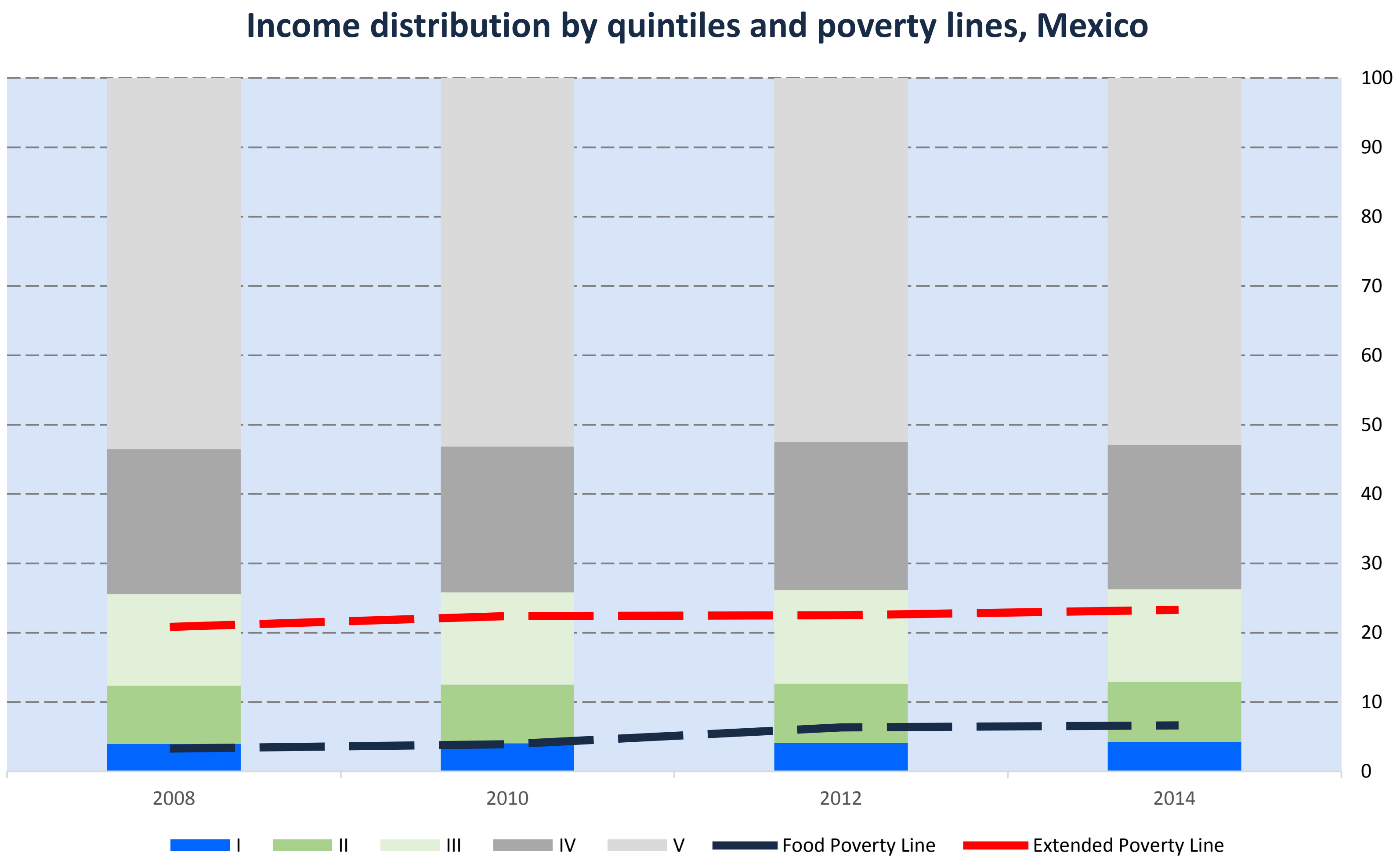
Source: *Banco de México* with data from SWIID v5.1 (Solt 2016).

Gini coefficient, 2012
Percentage



Source: *Banco de México* with data from SWIID v5.1 (Solt 2016).

Poverty and inequality seem to be linked.



Source: *Banco de México* with data from *INEGI* and *CONEVAL.*
Food Poverty line*: Monetary value of a basic food basket.*
Extended Poverty line*: Monetary value of a basket of basic foods, goods and services.*

Poverty and inequality seem to be linked.

- Higher poverty tends to go hand in hand with higher inequality (Atkinson, 2015).
  - *In Mexico, inequality and poverty are highly correlated (Székely, 2005).*
  - *In 2014, 53.2% of the total population in Mexico was below the extended poverty line.*
  - *Martinez (1998) finds evidence that for a country like Mexico, higher inflation is associated with higher inequality as measured by the Gini index.*

- However, even if there is a strong relationship between inequality and poverty, that does not mean that they are the same problem or that the policies to deal with each are the same.

- Nevertheless, a monetary policy that focuses on keeping inflation under control lays the ground for the reduction of poverty and can indirectly contribute to the long-term reduction of inequality as well.

Crisis-prevention and crisis-management by central banks are crucial in avoiding sharp increases in poverty.

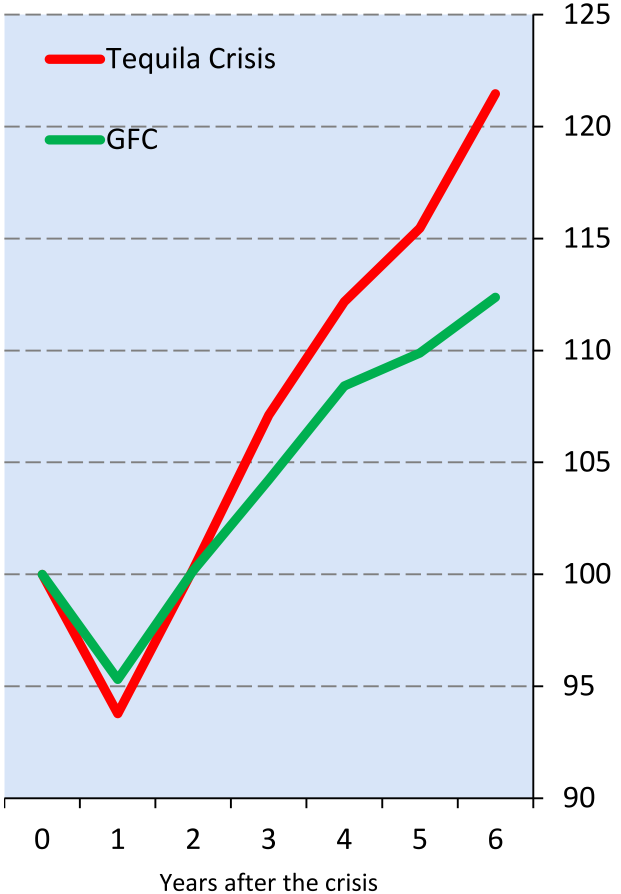
- Following the 1994-1996 Tequila crisis, there was an important increase in poverty in Mexico.
  - *In 1996 poverty reached levels similar to those observed 30 years earlier (Székely, 2005).*

- During the Global Financial Crisis of 2008-2009, the consolidation of an independent and credible Central Bank in Mexico which pursued a clearly defined inflation target was an important factor to keep inflation under control.
  - *Despite the fact that the negative effect on output was similar, changes in poverty this time around were relatively modest.*

Crisis-prevention and crisis-management by central banks are crucial in avoiding sharp increases in poverty.

Real GDP

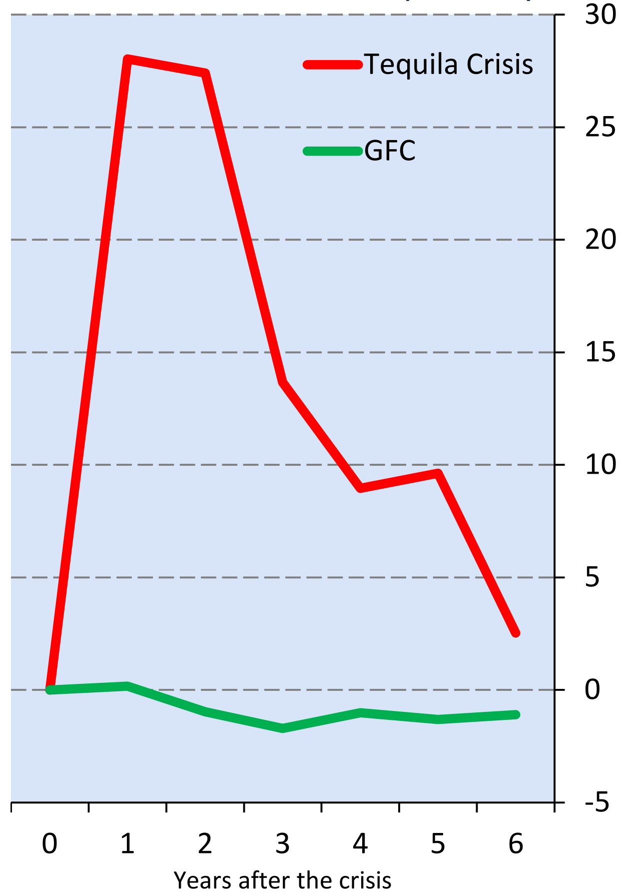
Index 1994=100 and 2008=100



Source: *Banco de México* with data from *INEGI*.

Inflation

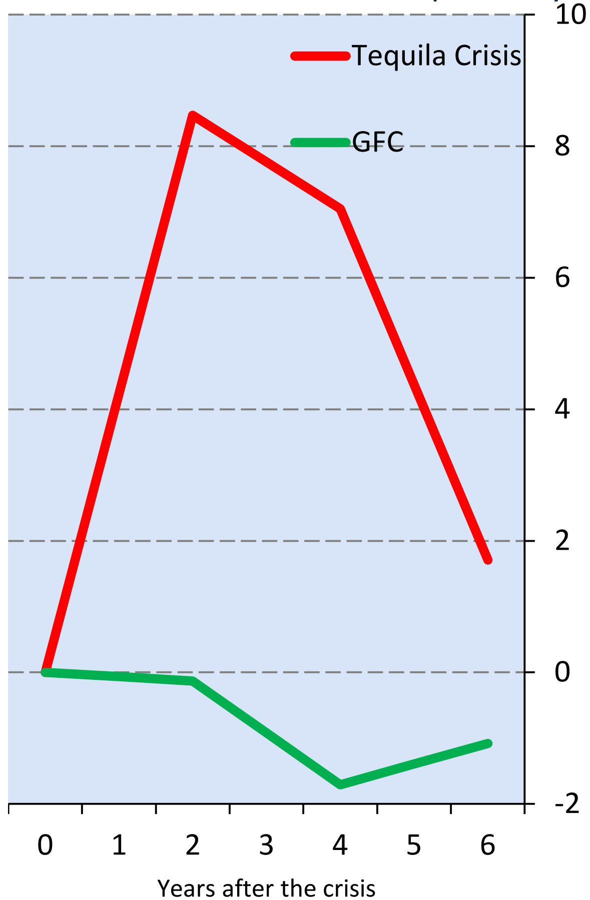
Basis points deviations from its level in 1994 and 2008 respectively.



Source: *Banco de México* with data from *INEGI*.

Poverty*

Basis points deviations from its level in 1994 and 2008 respectively.



Source: *Banco de México* with data from the World Bank. *Poverty headcount ratio at $3.10 a day (2011 PPP) (% of population).

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Conclusions

- The primary concern of an emerging market's Central Bank should be to keep inflation under control.

- Monetary policy is unlikely to be an effective tool for directly reducing inequality.
  - *However an effective monetary policy lays the ground for the long-term reduction of poverty and inequality.*
    - *High inflation is particularly harmful for the poor.*
    - *Inflation under control is a necessary condition for crisis management and crisis prevention.*

- Hence, an emerging market's central bank´s role in reducing inequality and poverty should focus on fulfilling its inflation mandate.

Conclusions

- Further reduction of poverty and inequality should be achieved through economic policies other than monetary policy.
    - *This does not mean that an emerging market's Central Bank must be passive about poverty and inequality.*

- Indeed, a relevant way in which a central bank can contribute to the reduction of poverty and inequality is by supporting and promoting economic structural reforms that raise investment, productivity and market competition:
    - *This reforms, in turn, will facilitate the Central Banks's job of keeping inflation low and stable.*

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