1 Feature Article

Central Banking and Inequality: The Current State of the Conversation

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HIGHLIGHTS

- **Monetary policy has a short-run and possibly medium-run impact on inequality. In the long run, the distributional impact is not clear.**
- **Incorporating inequality into policy deliberations may help achieve a more effective monetary policy.**

Introduction

For a long period, "benign neglect" characterised the attitude that central bankers displayed towards inequality (Monnin, 2014). Traditionally, the mandates of central banks and inequality are considered to be independent of each other.

However, since 2011, frequent statements have been made that seem to suggest that a rethinking of monetary stance on inequality may be needed (Monnin, 2014)[1]. For example, in October 2014, Yves Mersch, a member of the European Central Bank (ECB) Executive Board, asserted that "all economic policy-makers have some distributional impact as a result of the measures they introduce – yet until recently, such consequences have been largely ignored in the theory and practice of monetary policy." Figure 1 provides a timeline of milestones that may explain the recent popularity of inequality among central bankers.

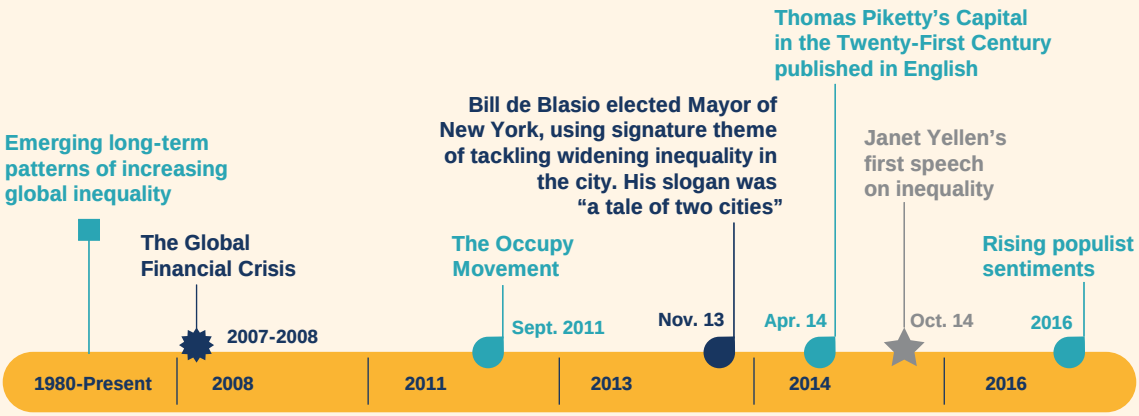
Building on the work by Monnin (2014), this article reviews selected studies and statements by officials of three major central banks – the Fed, the Bank of England (BOE) and the ECB – on the interaction between central banks and inequality. The findings can be summarised into the following three questions[2]:

- Does monetary policy influence inequality?
- Should central bankers consider inequality in their monetary policy deliberations?
- How can a central bank address inequality?

[1] Ibid. Note: Among major central banks, statements about inequality are especially more frequent after Janet Yellen, at a conference organised by the Boston Fed in October 2014, spoke about inequality. It marked her first speech as chairwoman focused exclusively on inequality. Nevertheless, she did not make any links between this issue and monetary policy.

[2] These questions are adapted from ones discussed in Monnin (2014).

Figure 1: Factors contributing to the rising popularity of inequality



1) Most central bankers acknowledge that monetary policy has a short-run and possibly medium-run impact on inequality. The long-run effect, however, is subject to debate.

The mechanism in which monetary policy affects inequality depends on several factors; namely the current distribution of assets between the rich and the poor; and the responsiveness of households and firms towards changes in the monetary policy stance.

In an environment of loose monetary policy and rising inflation, a low interest rate environment will benefit net borrowers while reducing the rate of returns on savings. As such, the short term impact could be to widen the income gap if the rich are net borrowers while the poor are net savers. Furthermore, if loose monetary policy fuels asset prices, the rich who tend to own more assets than the poor and middle classes, would also disproportionately gain from higher asset prices. Over the medium-term, however, an accommodative stance will lead to a reduction in unemployment. If labour market outcomes (wages and employment prospects) become relatively more favourable for the poor, then income inequality may narrow.

In the long run, things are less clear. Would the above distributional effects cancel each other out, such that there is no long-run distributional impact of monetary policy? Or, would they reinforce each other, in which case, monetary policy is responsible for the rising long-term trend in inequality. Below are selected statements made by representatives of major central banks and the IMF on this issue:

Bank of England (2014 and 2016)

- Over the shorter term, central bank policies can affect inequality; for example through extraordinary monetary accommodation which has boosted asset prices and exacerbated inequality.
- However, the tools at the disposal of central banks; i.e. interest rates, money supply, regulations cannot reshape the long-term structural trends in the economy.

ECB (2016)

- Over the medium-term, monetary policy reduces unemployment, which benefits poorer households the most. A faster return to full employment should, in turn, contribute to lower future inequality.

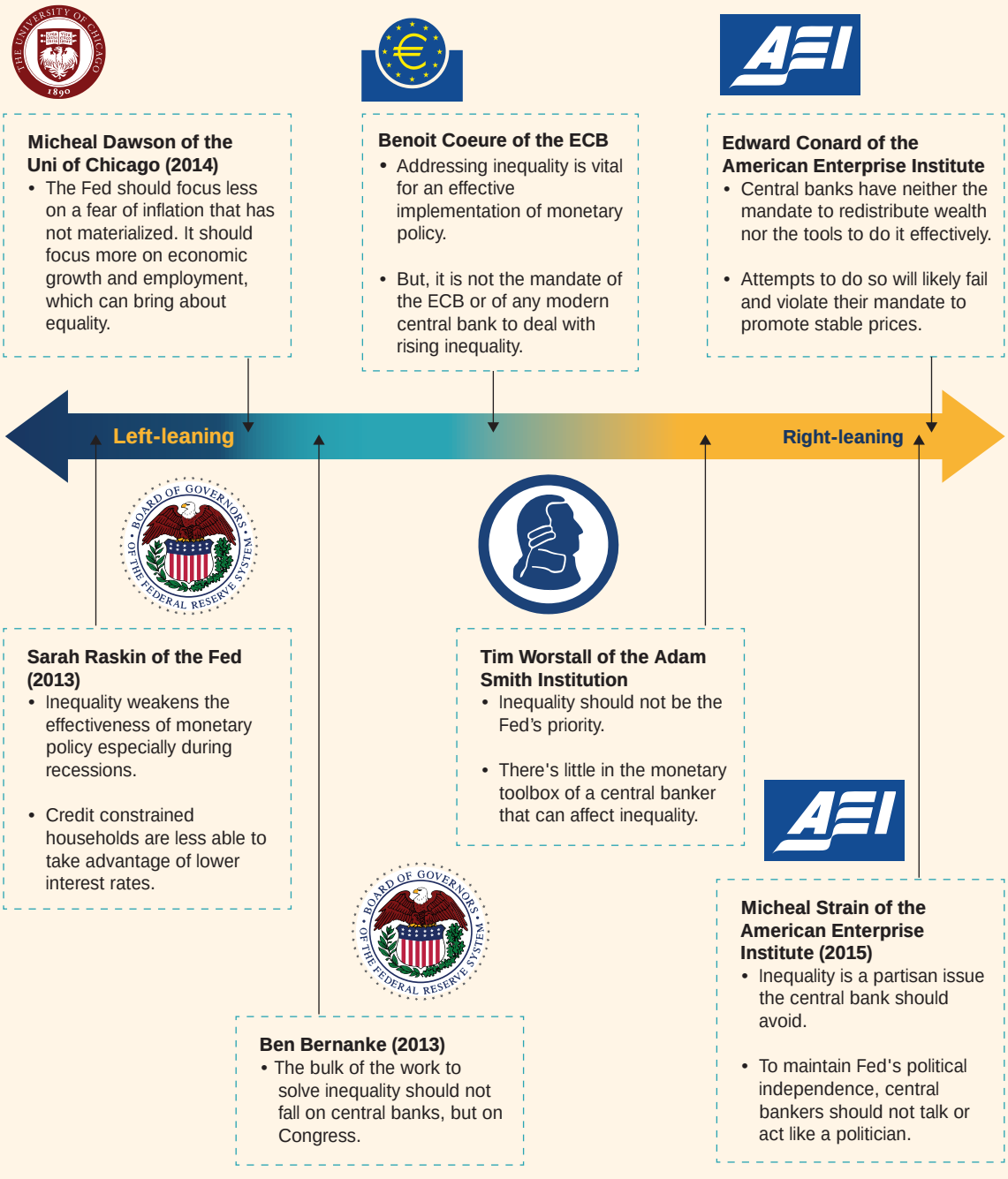
The IMF (2012)

- Monetary policy shocks play a significant role in cyclical fluctuations in inequality, but cannot account for the increasing trend in income inequality.

2) Incorporating inequality into policy deliberations is generally agreed to help achieve a more effective monetary policy. Incorporating inequality into a central bank's mandate however, is perceived as radical.

Figure 2 shows the views of select policy-makers and scholars along their partisan lines. Left-leaning policy-makers and scholars have advocated for greater scrutiny of inequality in monetary policy deliberations. Those on the right have preferred for central banks to focus on its traditional mandates. There is a general agreement that inequality dampens the transmission of monetary policy. Despite this, there is a broad sense of reluctance for the existing mandates of central banks to be revised to include an additional goal of curbing inequality.

Figure 2: Statements on whether inequality should be considered in monetary policy deliberations across political spectrum



3) Central banks have limited tools (e.g. regulatory policies) which are at best indirect, incidental and transient in redistributing wealth. But, as long as achieving their traditional mandates is not compromised, they could consider the distributive effects of their policies.



Janet Yellen (2017)

- Monetary policy cannot boost real GDP growth over the longer run or address the root causes of income inequality.
- But, the Fed still has a vital role to play in addressing issues around economic opportunity and inclusive growth.

BROOKINGS

Brookings Institution (2015)

- Monetary policy is blunt and its distributive effects are not clear. But this should not prevent the Fed from pursuing its mandate to achieve maximum employment and price stability, thereby providing broad benefits to the economy.



Joseph Stiglitz (2014)

- Central banks should be bolder in their regulatory role to help tackle inequality. For example, they can work towards preventing abusive credit card practices, usurious interest rates, and predatory and discriminatory lending, which are especially costly to the poor.



Fontan et al (2016)

- Central banks could address inequality in two ways:
  - o Using distributive concerns as tie-breakers. If a central bank can choose between two policies that perform equally well with respect to its mandates, it should choose the more equitable policy.
  - o Revising the existing mandates of central banks to include a permanent objective of curbing inequality.

Bank Negara Malaysia has been mindful of the implications of policy on inequality and its distributional consequences on various segments of the economy. In this regard, the Bank has ensured that the mandate on financial inclusion remains on track. In addition, the Bank has carried out specific research on affordable housing and the impact of debt on inequality to get a better grasp of the issues faced by the households. Granular data analysis, for example on the distribution of wealth by age groups and income groups, is used extensively to deepen understanding on the distributional impact of monetary policy.

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