2023

IARIW–BANK OF ITALY CONFERENCE “CENTRAL BANKS, FINANCIAL MARKETS AND INEQUALITY”

Paper Prepared for the IARIW-Bank of Italy Conference, Naples, Italy, March 29-April 1, 2023

Monetary Policy and Inequality

Marco Jacopo Lombardi

Emanuel Kohlscheen

Egon Zakrajsek

Income inequality has been increasing steadily for several decades, especially in advanced economies. Since the Great Financial Crisis, the growing debate on inequality in academic and policy circles has started involving central banks, too. Some commentators have suggested that exceptionally low interest rates and asset purchases might have benefited mostly the rich, thereby exacerbating inequality.

Monetary policy inevitably has distributional consequences: even the most basic and conventional easing -- a reduction in the policy rate -- directly shifts income from lenders to borrowers. That said, there are multiple and less direct transmission channels that affect the income of different groups in a heterogeneous manner: unemployment, inflation, returns of financial assets all respond to monetary policy to a varying extent. Hence, the question of whether monetary policy contributes to inequality, or rather helps mitigating it, is ultimately an empirical one.

To be sure, empirical research seems to suggest the labour market channel plays an overwhelming role: monetary stimulus, by boosting employment and hence the income of the previously unemployed, typically the poorest at the fringes of labour market, dampens income inequality (see, among others, Lenza and Slacalek 2018).

While studies on the impact of monetary policy on inequality abound (for a survey, see Colciago et al. 2018), the other side of the coin -- that is, the influence inequality exerts on the formulation, the conduct and the transmission of monetary policy -- has been studied much less. It is reasonable to expect that inequality -- being a somewhat structural feature of the economy, has a bearing on how monetary policy transmits and hence possibly on how it should be conducted. In fact, recent advances in the theoretical literature emphasise the importance of heterogeneity among agents -- including in terms of their income and wealth -- in shaping optimal policy prescriptions (Kaplan and Violante 2018). More specifically, an economy where income and wealth are very polarised in the hands of the rich is less reactive to monetary policy stimulus because the very rich are unlikely to boost their already high consumption, while the very poor are likely to be credit constrained due to their low income and wealth. Hence, the poor would not benefit much from the direct effects of easy monetary policy -- the possibility to borrow at cheaper rates -- but rather from its indirect effects through higher employment and better wages.

This paper investigates empirically how income inequality affects the transmission of monetary policy shocks in a panel of advanced economies, as well as across US states. Our results provide broad support for the idea that high inequality weakens monetary policy transmission, and hence provides empirical support to the findings of the recent theoretical literature on monetary policy in heterogeneous-agents models.