
**WORKING PAPER
N. 267
JANUARY 2026**

POPULISTIC SURFING: CONSENSUS, MONETARY AND BANKING POLICIES

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Populistic Surfing: Consensus, Monetary and Banking Policies

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January 2026

Abstract

This chapter, using a political economy approach, uncovers the relationships between populism, on the one side, and monetary and banking policies, on the other side. The analysis is based on three assumptions. First, both monetary and banking policies can produce redistributive effects. Second, political consensus can be associated with redistribution. Third, populists, being politicians, are myopic players, hence heavily influenced by citizens' financial and group heterogeneities. Given these assumptions, two different models are studied. Concerning monetary policies, a nexus between populism and central bank (in)dependence (CBI) can emerge where the populist aim to influence the monetary policy design after a macroeconomic shock that requires public bailouts. Regarding banking policy, our chapter defines populism as Democratic Rioting, in which citizens are assumed to be heavily influenced in their policy choice by psychological group dynamics. This explains why populist consensus emerges and may deliver different policy choices depending on non-banking news such as public welfare choices and immigration.

JEL Classification: D72, D78, E31, E52, E58, E62, E71, P16

Keywords: Populism, Political Economics, Monetary Policy, Banking Policy, Inequality, Central Bank Independence, Behavioural economics

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1. Introduction

In light of the Great Depression, the Great Crisis and their aftermaths, the emergence of populism in the wake of financial crises has taken the stage in academic and public debates (Guriev & Papaioannou, 2022). This link is not a coincidence. Some explain populism from trade shocks that foster inequality (e.g. Colantone & Stanig (2017) and Backes & Mueller (2024)), others with increase in salience of immigration and increase in economic inequality as drivers of the long-term dynamics of populism (Bischi et al. (2022))¹. There is also empirical evidence supporting that financial crises are a strong and significant predictor of a subsequent increase in support for populist and far-right parties². A growing body of empirical literature establishes a strong causal relationship between financial crises and subsequent political polarization and the rise of anti-establishment parties (Mian et al. (2014); Guriev & Papaioannou (2022)). More generally speaking, banking crises affect political outcomes and voting behavior (Panunzi et al. (2024), Gavresi & Litina (2023), Funke et al. (2023); Huynh & Uebelmesser (2024)). Moreover, politics becomes more ideologically extreme and takes a hard turn to the right (Funke et al. (2016), Mian et al. (2014) and de Bromhead et al. (2013)). Finally, parliaments become more fractionalized and governments less solid.

Two questions emerge. First, how is the emergence of populism related to decisive public policy decisions such as monetary and banking policies? These dimensions are particularly sensitive to changes in policymaking and conversely, they strongly define the policy debate. Indeed, monetary policy conduct has always been a pillar of macroeconomic stability since the late 1980's saw the start of the process of fundamental change from dependent and fine-tuning central banks to independent and conservative ones. Moreover, banking policies are tightly related to monetary policy, bailouts and the redistributive issues that comes with them. Second, how do we reconcile the evidence that populist parties propose heterogeneous policies in monetary and banking policies, while being electorally successful?

This chapter applies two political economics models with a common approach to understand the nexus between populism on one side and monetary and banking policies on the other side. The first model studies populism and central bank independence (CBI) when a macroeconomic-wide banking shock induces two distinct, but subsequent decisions on bailout and fiscal monetization. In this setting, populism attracts consensus because they propose policies that pressure status-quo institutional settings based on individual financial heterogeneities³. Voter preferences are consistent with the socially optimal

¹ Autor et al. (2020) and Colantone & Stanig (2017) are examples of the trade shock explanation arguing that voting patterns are influenced by global competition, especially through the effect of decreased wages among unskilled workers in developed countries.

² The link between financial instability and political polarization is well-documented. Funke *et al.* (2016) conduct a comprehensive historical analysis covering over 800 elections in 20 advanced economies from 1870- 2014. They find that financial crises are consistently followed by significant political turmoil. Specifically, in the five years following a financial crisis, vote shares for far-right parties increase, on average, by over 30 percentage points. They conclude that financial crises are a more potent driver of far-right support than normal recessions. Similarly, Mian *et al.* (2014) find that the 2008 financial crisis led to a sharp increase in political polarization in the U.S., with voters in areas hit hardest by the household debt crisis being more likely to elect ideologically extreme representatives.

³ In fact, evidence suggests that as the negative effects of financial crises are generally severe, politicians tend to intervene by changing the policy design (Saka et al., 2020) and/or the corresponding institutional setting

policies if and only if financial portfolios are homogeneous. In the case they are not, median voter support for populist policies would depend on the composition of his/her financial portfolios respect to the average voter with respect to deposits and public bond holding. For example, a median voter that is a larger depositor than the average would prefer larger bailout policies for banks, while a median voter that owns more bonds than the average would prefer a more conservative monetary policy to enjoy higher interest rates. Certain kind of right-wing populists may like more conservative banking and monetary policies, while certain kind of left-wing populists may like laxer banking and monetary policies.

The second model studies monetary and banking policies and populist vote under psychological group dynamics. Citizens vote for populists when psychological benefits exceed economic costs, hence being influenced by political features that are far from the policy choice at hand. The economic costs of voting for the populists come from choosing a suboptimal policy that the populists propose after evaluating the political opportunity space. This framework explains why different policy choices championed by different populists are still compatible with citizens diminished support for traditional parties. Specifically, populist parties had heterogeneous proposals about the design of bailout policies in the aftermath of financial turmoil. In some cases, they favored generous bailout policies—as in Poland in 2015; in other situations, they adopted a position against the bailout solution proposed by the incumbent, traditional parties—as in Italy in 2017⁴. In this setting, the underlining macroeconomic model is the same as the first model presented, but the citizens are assumed to decide what party to vote based on both psychological and economic principles, not just the composition of their financial portfolios. This is a model of Democratic Rioting since the psychological benefits of voting are modelled through anger, the higher the more citizen expectations differ from group-specific reference points. The similarity to rioting comes from the display of anger that is through party support instead of street protesting (Passarelli and Tabellini 2017).

A definition of populism that is common to both models is the one used by Cas Mudde (2004, 2010) and Mudde and Rovira-Kaltwasser (2017): populism is a “thin-centered ideology” that considers society to be ultimately separated into two homogenous, antagonistic groups that are the “pure people” and the “corrupt elite.” Populist movements claim that they protect the people from the elite. The people, in turn, share a demand for short-term protection. These movements appear to be characterized by two main properties (Guiso et al., 2017; Rovira-Kaltwasser 2018; Saint Paul, 2020): the accommodation of certain demand conditions and a disregard for future consequences. The fact that populist policies are both redistributive and myopic is a constant theme in the literature focused on the economic aspects of populism (Acemoglu et al., 2013; Chersterley & Roberti, 2018; Dornbusch & Edwards, 1991; Sachs, 1989). After the first wave of populism, which was mostly concentrated in Latin America (Dornbusch and Edwards 1991, Acemoglu et al. 2013), a second wave of populism gained ground in many European countries and the United States, leading to both left-wing and right-wing movements. Such movements directly and/or indirectly influence the design and implementation of different kinds of economic policies (Dovis et al. 2016, Aggeborn and Persson 2017, Rodrik 2017).

The first part of the chapter illustrates the results obtained in Masciandaro and Passarelli (2020) regarding the relationships between populism, economic policy design and central bank independence

(Masciandaro & Quintyn, 2016). These actions are likely to be politically motivated (Dalla Pellegrina & Masciandaro, 2008; Saka et al., 2020).

⁴ For further details on these two opposite cases see Favaretto and Masciandaro (2022).

(CBI). Some researchers argue that the rise of populism may negatively affect the consensus in favour of central bank independence (CBI) which has been evident from the late 1980s until the 2008 Great Crisis (Buiter 2016, de Haan and Eijffinger 2017, Goodhart and Lastra 2017, Rajan 2017, Rodrik 2018). Recent development regarding the U.S. Federal Reserve tend to confirm this view. By the time of the 2008 Great Crisis, the independence of central banks had become the benchmark for evaluating the effectiveness of monetary institutions around the world. This institutional design was supported by a broad consensus (Cecchetti 2013, Bayoumi et al. 2014, Goodhart and Lastra 2017, Issing 2018). The theoretical bottom line is well known (Cecchetti 2013, Eijffinger and Masciandaro 2014): incumbent policymakers tend to use monetary tools for short-term purposes and for smoothing out various kinds of macroeconomic shocks, including real (Barro and Gordon, 1983) and fiscal (Sargent and Wallace, 1981) imbalances. However, the more markets are efficient, the greater the risk that the short-sighted monetary policies will produce just macro distortions and imbalances. Therefore, the rules of the game between policymakers and central bankers became relevant (Barro and Gordon, 1983; Backus and Driffill, 1985; Rogoff, 1985; Lohmann, 1992, Persson and Tabellini 1993), triggering a significant stream of literature on CBI.

The evolution of this research field occurred in two steps. Initially, scholars involved in the field worked on verifying theoretical conjectures through comparative, institutional and empirical analyses. Then, after constructing CBI indices (Grilli et al. 1991, Cukierman et al. 1992; Alesina and Summers, 1993), they used cross-country studies and time series analyses to determine whether and how the different indices could be considered as drivers of the most important macroeconomic phenomena, including inflation (Klomp and De Haan 2010) and fiscal variables (Bodea and Higashijima 2017). In some cases, researchers evaluated a country at a particular point in time (Acemoglu et al. 2008). However, as CBI is sometimes included as one component of a larger reform package or is viewed as part of a more complex series of events, establishing causality has been challenging (Bayoumi et al. 2014).

This increased interest mainly reflects the fact that the economic and political importance of the central banks in the advanced economies has grown since the beginning of the 2008 Great Crisis (Buiter 2014). Supervisory and regulatory responsibilities have been piled onto the central banks, thereby intensifying the relationships among banking, fiscal and monetary policies (Bayoumi et al. 2014, de Haan and Eijffinger 2017). The boundaries between the central bank's role as liquidity manager and the government's solvency support for banking and financial institutions have been blurred, inevitably triggering a debate on the shape of the central bank regimes (Nier 2009, Bean 2011, Cecchetti et al. 2011, Ingves 2011, Reis 2013), especially with regard to the features of CBI (Cukierman 2008 and 2013, Cecchetti 2013, Taylor 2013, Buiter 2014, Blinder et al. 2017). These aspects have also been in focus from a historical perspective (Bordo and Siklos 2017, Ugolini 2017).

In this vein, an important question is whether the policy-blurring effect has made the pendulum swing in the other direction. Thus far, comparative analyses have not offered homogenous results (Bodea and Hicks 2015, de Haan et al. 2018, Masciandaro and Romelli 2018a). Here we zoom in this policy-blurring effect and sheds light on the possible impact in terms of CBI. On this respect we discuss the concept of political pressure, as a proxy of a potential demand for reforming the legal CBI, or as an indicator of the actual – as opposed to legal – CBI (Binder 2018b).

More specifically, we elaborate on the political pressures due to the existence of both left-wind and right-wind populisms. It has been correctly pointed out (Colantone and Stanig 2019) that the populist parties are very heterogeneous; besides the traditional the classical left-right divide, one more dimension is likely to be relevant: nationalism versus cosmopolitanism.

Here we would like to emphasize one more feature that both left-wind and right-wind populism: they can consider unwelcome the veto players that characterize liberal democracies. In general, the populists tend to dislike the autonomous institutions – as the modern central banks – that are neither directly controlled nor directly elected by “the people” (Rovira Kaltwasser 2018). Specifically, the existence of independent central banks is in contrast with the need of using lax monetary policy to implemented short-sighted strategies, as it is particularly evident in the case of Latin American countries before 1990 (Edwards 2019)⁵.

The populist narrative stresses the idea that the general will should prevail. Thus, liberal institutions are less useful - e.g. the separation of powers, checks and balances, the representative democracy, and intermediate state institutions. CBI is one of those institutions. Its aim is to ensure neutrality and the inter-temporal consistency of monetary policy. Curbing the independence of central banks would be consistent with the populist goal of exerting direct control over conflicts within society (Goodhart and Lastra 2017).

All in all, we can define as populist a politician who seeks to remove the checks and balances generally applied in a democratic state - e.g. CBI - in order to fulfil promises made during the election campaign. In other words, it encompasses politicians acting as autocratic policymakers (Goodhart and Lastra 2017). It is worth noting that the autocracy seems to be inversely correlated with CBI (Bodea et al. 2019).

Moreover, also the anecdotal evidence shows that in general the central bankers are facing political scrutiny of an intensity not seen in recent decades. In several occasions, especially in late 2025, U.S. President Donald Trump ramped up his personal war of words with the Federal Reserve. On December 2018 the governor of India’s central bank resigned after dispute over independence. On March 2019 Italy’s ruling populists tried to seize control of the central bank and its gold reserves. It is worth noting that at the time the government was led by an heterogeneous populist coalition. On June 2019 in South Africa the ruling party attacked the independence of the central bank. On July 2019 the Turkish governor was fired.

The second part of the chapter builds on the Democratic Rioting model by Favaretto and Masciandaro (2022) by using the same macroeconomic context of the first part of the chapter and adding a political economy decision. Within this macroeconomic framework, there is an optimal bailout policy after the banking shock. Each citizen works the same hours but has a different amount of wealth than she or he had in the past. This implies that every citizen compares herself or himself to one of the two wealth groups: rich and poor. The assigned group matters in terms of the psychological benefit derived from voting for populists. In short, each citizen has a probability of voting for the populists that depends on three features: whether that citizen is angry with the mainstream party, whether that citizen compares herself or himself to the rich or the poor, and the individual costs of voting for the populists. Psychology drives the first two motivations, while economics explains the third.

We assume that an aggregate negative banking shock generates a positive probability of voting for a populist party by acting on the demand for populism⁶. A generic populist party offers an alternative to

⁵ In other words, the notion of central bankers seems to provide a natural target for populist policies. On top of that, “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).

⁶ We assume that there would be a supply of populism, given the increased demand.

a mainstream⁷ party that represents the optimal policy choice. The extent of the bailout intervention is to be decided through the electoral competition. We assume that this will be the only policy dimension on which to vote (Persson & Tabellini, 2002). In this model, monetary and fiscal policy interact but voters only choose the latter. This setup replicates a common institutional setting seen in the advanced economies starting in the 1980s—a monetary dominance regime (Masciandaro & Romelli, 2015). In such a regime, monetary policy is in the hands of an independent central bank, while the government controls fiscal policy.

The citizens' decision is a behavioural decision—it is not only economic but also driven by emotions. In this regard, what other group members do matters for the individual. On the other hand, any wealth group has a reference point, which depends on group information. Therefore, the wealth group's reference point is influenced by news about immigration, welfare plans, and housing plans. This, in turn, generates “democratic rioting.” This mechanism moves the reference point and generates fuel for the populist vote, and the political consensus on specific bailout policies becomes dependent on several issues that have nothing to do with the policies themselves. In other words, the consensus on specific banking policies becomes a general political manifestation of anger and frustration.

Our model is based on several papers. In general, individual decision-making is influenced by psychological factors (Nowakowski, 2021). First, several papers recognize the fact that populists use myopic, short-term solutions that benefit certain subgroups of the population. Such policies are often harmful in the long run (Acemoglu et al., 2013; Chersterley & Roberti, 2018; Dornbusch & Edwards, 1991; Sachs, 1989). Second, empirical evidence supports the association between wealth groups and populism. Moriconi et al. (2018) show that the inflow of less educated immigrants is associated with an increase in votes that favour nationalistic positions and that this association is stronger for non-tertiary educated voters. Giebler and Regel (2018) find that the “Poors” vote more for right-wing populists, as these individuals are more likely to be unemployed and have less education. Moreover, from a theoretical point of view, Bischi et al. (2022) show that fear of immigration can drive people to support populism. Third, and more generally, studies in social psychology underline that individual voting can be affected by group affiliation through group norms, information and concepts of identity (Gerber & Rogers, 2009; Huckfeldt & Sprague, 1995; Tajfel, 1982).

2. Citizens, Macro Shocks and Economic Policy Options

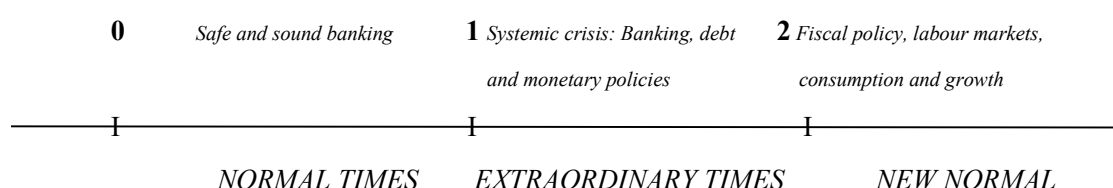
This section describes the Masciandaro and Passarelli (2020) setting that studies the relationship between economic policy design and political pressure in order to analyse under which conditions populist policies aimed to reform the CBI can emerge. The framework mimics an economy in which a macroeconomic shock occurs. Then the policymakers are forced to design a policy involving at the same time banking, fiscal and monetary aspects aimed at minimizing the spillovers of the shock into the real sector. The incumbent government define the banking and fiscal policies, while an independent central bank sets the monetary policy choices, i.e. the degree of fiscal monetization.

The economy consists of a population of citizens, a government, a central bank and a banking system. The sequence of events is as follows (see Figure 1). At $t=0$, banks engage in business with some level of risk (*normal times*). The outcome of their activities determines the extent to which the banks' risk

⁷ Centre-right or centre-left party.

profile is safe and sound. Without a bank crisis, the government does not need to issue debt and, consequently, there is no need to introduce distortionary taxation to service such debt. But at $t=1$, bank failures that trigger public externalities can occur and, consequently, the government has to design its strategy (*extraordinary times*). This public policy involves two decisions, one regarding the banking policy - i.e. the bailout amount - and another regarding the fiscal policy - i.e. how to finance such a bailout. In turn the degree of fiscal monetization will depend on the central bank decisions. Given that the government issues public debt for the amount of the bailout and that government bonds can be purchased by either citizens or the central bank, the degree of fiscal monetization is the amount of public debt to which the central bank decide to subscribe.

Figure 1 : *Normal Times, Extraordinary Times and New Normal Times*



Source: Masciandaro and Passarelli, 2020.

At $t=2$, the government introduces an income tax to repay debt and interest. The citizens make decisions about labour, consumption and income given the tax, and the central bank transfers payments for interest received on its bond purchases back to the government (*“new normal” times*).

The economic policies that adopt a long-term perspective, including the central bank choices, will be the socially optimal ones. In other words, the social planner equilibrium in the new normal times will reflect the intertemporal trade-off between minimizing tax distortions and smoothing out banking externalities. The social planner equilibrium implies that the optimal economic policy design produces homogeneous effects. But if the policies trigger heterogeneous effects on the country’s citizens, different individuals will have different views regarding those policies. This is crucial as long as the citizens’ preferences are relevant in the political process. Therefore, the final policy is not automatically equal to the socially optimal one.

The model focuses on heterogeneity among citizens in terms of financial inequality given that the mix between fiscal, banking and monetary policies can produce the so called “three D” effects (Goodhart and Lastra 2017). The Distributional Effect results from changes in interest rates. The Directional Effect captures the impact of public policy on a certain sector and/or constituency of the economy, such as the banking industry (Brunnermeir and Sannikov 2013). The Duration Effect measures the monetary policy’s effect on overall public-sector liabilities, including the central bank’s balance sheet within the public sector. In this regard, more fiscal monetization reduces the duration and can be associated with monetary instability.

In our analysis the Directional Effect depends on banking policy choices, while the Distributional effect and the Duration effect are associated with the corresponding fiscal and monetary policies. Given that the first ring in the overall chain of events is the likelihood of a banking crisis, the banking activities are the starting point. The systemic risk that a banking crisis can produce depends on the behaviour of the banking sector. A banking crisis occurs if the bank is unable to meet its obligations. In such an event, the value of the bank’s liabilities falls to zero, and the bank’s shareholders bear the full cost of the crisis (bail-in). The bank’s failure probability is associated with its risk assumption.

When a crisis occurs, a bailout policy can be designed that injects fresh public capital in a proportion of the bank's value. The bank chooses the risk profile that maximizes its own expected equity value, while taking both the crisis event and the bailout likelihood into account.

The second ring in our narrative is the government's behaviour. When a bank fails, the government enters an environment of extraordinary times and faces a trade-off: let the bank fail or rescue it by injecting new capital. In the latter case, the government issues public debt for the amount of the bailout. Public bonds can be purchased by either citizens or the central bank. The central bank's purchases represent the fiscal monetization.

The government's policy will influence the economy through the behaviour of the citizens, which is the third and final ring in our chain of events. The citizens are risk neutral, and they draw utility from consumption and disutility from labour. They use their net labour income and their financial assets to buy consumption goods. Income and labour supply in equilibrium will depend on the tax policy, which can be influenced by the government's decision regarding the bailout option. Moreover, the government's decisions also influence the financial assets held in the individual portfolios. Four asset types are present: bank shares; bank deposits; government bonds; and other financial assets.

Finally, financial and monetary externalities are present due to a banking crisis. The externalities are increasing and convex in the amount of bank liabilities that evaporate, and they depend on the bailout option that the government can implement. The smaller the bailout policy is, the lower the Direction Effect and the greater the externalities. Moreover, the bailout option also triggers monetary policy consequences. The fiscal monetization is associated with increasing monetary stability costs. It is worth noting that the costs of monetary instability include as a particular case the costs of inflation, which has been usually used to justify the optimality of institutional settings with monetary dominance, i.e. where the central banks are relatively independent from the executive powers and/or involved in inflation targeting policies.

The last step is the identification of the benchmark for evaluating actual public policies. We assume that a social planner takes the relationship between the tax policy, and the labour supply into account, and simultaneously sets the policy strategy regarding the banking policy, and the monetary policy, in order to maximize the social-welfare function. When setting the banking policy, the social planner accepts a trade-off between two public goals: externality smoothing and tax-distortion minimization. This trade-off can be mitigated using monetary policy, but it also introduces the dilemma of monetary instability.

Focusing the attention on the central bank decisions, the optimal level of fiscal monetization (accommodation) has certain properties. It increases: a) if the labour supply is relatively elastic, given that the corresponding tax-distortion risk is high, b) if the cost of debt servicing is high and c) if the monetary instability costs are low. In other words, if both the Distributional Effect and the Duration Effect are likely to be low, the optimal central bank accommodation is likely to be high. In addition, recall that higher levels of the optimal bailout policy, will increase the overall amount of debt monetization (Directional Effect), notwithstanding the monetization parameter is held constant.

3. CBI and Populism

Economic policies have relevant redistributive effects, but the social planner described in the previous section is only concerned about economic efficiency. When it comes to the effects of such policies for individual citizens, the situation can be completely different, as the net transfers implied by efficient policies can be largely positive for some and largely negative for others.

The redistributive effects are a relevant issue as long as the policies are chosen through the political process - i.e. when the citizens are voters. The Masciandaro and Passarelli (2020) analysis considers majority voting with voter preferences that are associated with the financial wealth distribution. Therefore, the political pressure can be considered a proxy for a contingent demand of CBI reform; such interpretation can be confirmed observing that so far the political pressure seems to be uncorrelated with legal CBI (Binder 2018b).

In general, the median voter's preferences and, consequently, the features of his or her financial portfolio will determine the actual overall equilibrium. The more the politicians in charge accommodate the demand for an economic policy design that differs from the socially optimal one, the more a political pressure to change the central bank regime will be likely to be in action⁸. Under which conditions can a populist pressure occur? Given the above-mentioned definition (Guiso et al. 2017), a populist policy can be defined as any political decisions that guarantees short-term protection without regard for long-term distortions. In a way the populist policy is at the same time a myopic and redistributive action.

How does the standard link between myopic policies and CBI differ from the relationship that characterizes a populist policy? The standard view can be summarized as follows (Fischer 2015): the CBI is an institutional device used to avoid distortionary inflation tax given the political pressure, and this device is implemented using time-inconsistent policies (Kydland and Prescott 1977). Here, the trigger is financial inequality – not the unemployment rate – and the policy tool is the interaction among banking, fiscal and monetary policies, rather than monetary policy per se. Moreover, the inefficient macro-outcome is the overall taxation design, not just the inflation tax, which is produced without any particular assumptions about the players' expectations or information sets.

Table 1 presents all the possible equilibria. The columns show what happens when the median voter is a smaller/equal/larger depositor than the average voter, while the rows show what happens when the median voter is a larger/equal/smaller bond holder than the average voter. It is worth noting that in general (Meltzer and Richard 1981) the difference between mean and median income can be considered a measure of inequality. In every combination, the policy outcome is compared with the socially optimal policy. The outcome can be characterized as efficient if it is equal to the benchmark, conservative if it is more restrictive and laxer if it is more expansive. A lax banking policy can be defined as a situation of financial dominance (Smets 2013), while a lax monetary policy represents a case of fiscal dominance (Sargent and Wallace 1981).

⁸ For example, reforms that decrease the CBI owing to financial stability issues (Ueda and Valencia 2012) are more likely to occur.

Table 1: Median Voter Financial Identikit and Policy Preferences

	Smaller Depositor	Equal Depositor	Larger Depositor
Larger Bond Holder	Conservative banking policy Conservative MP	Efficient banking policy Conservative MP	Financial dominance Either conservative CBI or fiscal dominance
Equal Bond Holder	Conservative banking policy Conservative MP	Efficient banking policy Efficient MP	Financial dominance Fiscal dominance
Smaller Bond Holder	Conservative banking policy Either conservative MP or fiscal dominance	Efficient banking policy Fiscal dominance	Financial dominance Fiscal dominance

Source: Masciandaro and Passarelli, 2020.

A crucial fact emerges. In general, voters' preferences are consistent with the socially optimal policies if and only if the financial portfolios are homogeneous. The greater the financial heterogeneity, the more the equilibria differ from efficient levels.

4. Populism, Psychology and Banking Policy

The second model comes from Favaretto and Masciandaro (2022). The macroeconomic model is exactly as the one in the previous sections. The only difference is that the citizens employ a new way to decide for which party to vote and the monetary policy decision is made by an independent central bank, which chooses the optimal level of inflation. Differently from Masciandaro and Passarelli (2020), political pressures on the central bank setting cannot arise.

In terms of bailout policy, the populists present a different proposal than the mainstream party. The model allows the policy to be above or below the socially optimal level, depending on the specific political circumstances, even though we believe that populists usually prefer higher government spending and, hence, higher bailout policies (see, e.g., The Economist, 2018, "Battle over benefits").

Citizens decide whether to vote for the populist party by balancing the costs and benefits of this choice both economically and psychologically. The individual benefit of voting for the populists comes from expressing emotions in a way that has a public impact. Importantly, the individual benefit of voting for the populists increases along with the size of the individual's group. It is an indirect public display of emotions, so the more that is shared by group members, the more it pleases the individual. In the words of Passarelli and Tabellini (2017), "the psychological benefit of a public display of anger is stronger if the emotion is more widely shared" and is related to being treated unfairly.

Why does the psychological bias emerge? It can be caused by news about immigration, welfare plans, or housing plans. The group's bias increases when group participants feel entitled to a better public policy for various reasons, such as when they blame immigration or the other group for getting too

much public attention and resources. The bias acts as a wedge between the indirect utility of voters and their reference points.

Research indicates that such biases may be caused by immigration. Guiso et al. (2017) find that fear of immigrants affects voting decisions in favour of populists. Dennison and Geddes (2018) find a correlation between the salience⁹ of immigration (from the pan-European Eurobarometer survey) and the polling of anti-immigration parties in most western European countries for data after 2005.

Moriconi et al. (2018) find that the inflow of less-educated immigrants is positively associated with an increase of votes in favour of nationalistic positions, and that this association is stronger for non-tertiary educated voters and in response to non-European immigrants. In our framework, this means that the inflow of less-educated immigrants increases the biases of both the rich and the poor, but with a stronger effect on the poor. More specifically, the poor experience a higher level of distress, which increases the probability that they will vote for populists.

Some evidence suggests that the bias may be higher among the poor due to their higher exposure to the presence of immigrants in public spaces. In this regard, Card, Dustmann and Preston (2012) compare attitudes toward immigrants in Europe using data for 21 countries from the 2002 European Social Survey. They use a latent-factor model to account for the composition of local populations and the perceived threats to the compositional amenities that natives derive from their neighbourhoods, schools and workplaces. They find that compositional concerns are two to five times more important for explaining variations in individual attitudes toward immigration than concerns about wages and taxes. Moreover, most of the differences in opinion between more- and less-educated respondents is attributable to heightened compositional concerns among people with less education.

All in all, both the rich and the poor may have a probability of voting for populists that is greater than zero. For this to be true, both groups' anger must be positive. In our baseline framework the poor have a higher probability of voting for populists, as they have a higher bias and lower variance in the individual costs of voting for populists.

As seen above, higher bias may be the result of a higher impact of immigration coverage in the media and other information sources. This scenario is in line with the empirical evidence. Dorn et al. (2018) show that poorer German counties have higher shares of votes for extremist parties. Guiso et al. (2017) and Algan et al. (2017) find that economic insecurity is a dominant driver of populist voting, which is in line with the fact that the poor are more likely to be affected by economic hard times than the rich. In line Funke et al.'s (2016) finding that there is a rise in extremist right-wing parties after a systemic banking shock, we use a banking shock. We describe a mechanism that applies to the aftermath of the Great Recession with a timing similar to the emergence of right-wing parties during the Great Depression, as in De Bromhead et al. (2018). On top of that, our setting may incorporate a globalization effect on the poor through a bigger increase in their self-serving bias, which is in line with the literature on the political effects of trade shocks.

⁹ Salience is defined as the indication of the most important issue affecting the individuals and/or the country.

5. Conclusion

This chapter documents answers to two questions related to populism and monetary and banking policies. First, how is the emergence of populism related to decisive public policy decisions such as monetary and banking policies? Second, how do we reconcile the evidence that populist parties propose heterogeneous policies in monetary and banking policies, while being electorally successful?

This chapter applies two political economics models with a common approach to understand the nexus between populism on one side and monetary and banking policies on the other side. The first model studies populism and central bank independence (CBI) when a macroeconomic-wide banking shock induces two distinct, but subsequent decisions on bailout and fiscal monetization. In this setting, populism attracts consensus because they propose policies that pressure status-quo institutional settings based on individual financial heterogeneities¹⁰. Voter preferences are consistent with the socially optimal policies if and only if financial portfolios are homogeneous. In the case they are not, median voter support for populist policies would depend on the composition of his/her financial portfolios respect to the average voter with respect to deposits and public bond holding.

The second model studies monetary and banking policies and populist vote under psychological group dynamics. Citizens vote for populists when psychological benefits exceed economic costs, hence being influenced by political features that are far from the policy choice at hand. The economic costs of voting for the populists come from choosing a suboptimal policy that the populists propose after evaluating the political opportunity space. This framework explains why different policy choices championed by different populists are still compatible with citizens diminished support for traditional parties.

6. References

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¹⁰ In fact, evidence suggests that as the negative effects of financial crises are generally severe, politicians tend to intervene by changing the policy design (Saka et al., 2020) and/or the corresponding institutional setting (Masciandaro & Quintyn, 2016). These actions are likely to be politically motivated (Dalla Pellegrina & Masciandaro, 2008; Saka et al., 2020).

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