Social Capital and Monetary Policy

CFM-DP2022-19

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The U.S. have experienced a significant decline in generalized trust over the past three decades. Has this secular trend impacted central banking? Empirically, we document that states with high levels of institutional and interpersonal trust are robustly more responsive to monetary policy shocks. Theoretically, we embed a circle of trust block into the New Keynesian framework in continuous time. The calibrated model predicts that monetary policy has become 20% less effective due to the decline in trust. Our findings firm up the social capital channel of monetary non-neutrality and warn that crises of trust could lead to crises of policy inefficacy.