

RESEARCH BRIEF • JANUARY 2022

Inclusive Monetary Policy: How Tight Labor Markets Facilitate Broad-Based Employment Growth

Based on BFI Working Paper 2022-03, "[Inclusive Monetary Policy: How Tight Labor Markets Facilitate Broad-Based Employment Growth](#)," by Nittai K. Bergman, Tel Aviv University; David Matsa, Northwestern University; and Michael Weber, Chicago Booth

KEY TAKEAWAYS

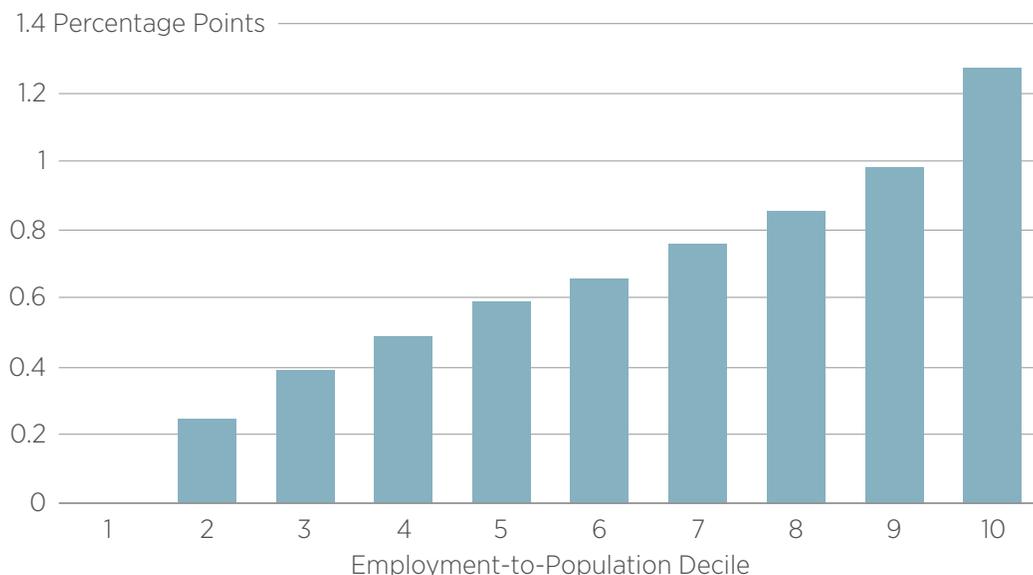
- ✓ The Federal Reserve is charged with promoting maximum employment, stable prices, and moderate long-term interest rates.
- ✓ Recently, the Fed has emphasized the need to focus on the employment rates of certain demographic groups rather than on just aggregate employment.
- ✓ This research shows that policymakers can, indeed, positively affect employment within targeted groups, but only in tight labor markets.
- ✓ Importantly, this work reveals a difficult tradeoff for policymakers: increasing employment vs. possible higher inflation.

In recent years, and especially in the wake of the Great Recession of 2008-09, the Federal Reserve has paid increasing attention to employment data that go beyond the broad unemployment rate. For example, a low aggregate unemployment rate may mask higher rates for groups that, on average, are not as firmly attached to the labor market, like women, Blacks, and the least educated.

In the past, while Fed policymakers would certainly acknowledge these discrepancies, they would also note the “blunt” nature of monetary policy; that is, the Fed can only set one interest rate for all participants in the economy and cannot focus monetary policy on demographic groups. The best way for the Fed to lift all demographic boats, in other words, is to deliver policy that sets the broad economy on a course for inflation-free growth.

However, new research from Booth School’s Michael Weber and colleagues is challenging that conventional wisdom. In “Inclusive Monetary Policy: How Tight Labor Markets Facilitate Broad-Based Employment Growth,” the authors find that for demographic groups with low average labor market attachment, monetary expansion can have a larger effect on employment growth in tight labor markets. That last point—tight labor markets—is key to this analysis and brings challenges for monetary policymakers.

Figure 1 • Predicted Black Employment Growth by Labor Market Tightness, Fourth Quarter 2000



Note: This figure plots the predicted differential effect of a one standard deviation cut in the federal funds rate on subsequent two-year Black employment growth across labor markets of different tightness, measured using deciles of the employment-to-population ratio. The deciles of employment-to-population ratio (across MSAs) are calculated in the fourth quarter of 2000. For each decile, the figure plots the additional predicted employment growth relative to that predicted for the lowest employment-to-population decile. Predicted values are calculated from the estimates in Panel A of Table 3 using the mean employment-to-population ratio for each decile.

Monetary policy for all?

“With regard to the employment side of our mandate, our revised statement emphasizes that maximum employment is a broad-based and inclusive goal. This change reflects our appreciation for the benefits of a strong labor market, particularly for many in low- and moderate-income communities.”

Jerome Powell

2020 Jackson Hole Economic Policy Symposium

As Chairman Powell and his colleagues know, appreciating the benefits of a strong labor market for all communities is one thing, achieving those benefits through monetary policy is another. Until now, policymakers and economists have had little understanding of the heterogeneous effects of monetary policy on different segments of the labor market. This novel paper sheds light on this vexing question and offers a path forward for policymakers. The key? Tight labor markets.

The authors’ analysis begins with an exploration of monetary policy’s heterogeneous effects with respect to workers’ race, education, and sex. To do this, the authors employ data from 895 local labor markets in the US between 1990 and 2019. For each demographic group they determine the level of employment growth relative to the

interaction between the federal funds rate (the Fed’s target interest rate) and the labor tightness in each local labor market. These local data allow the authors to account for many factors, including industry-level effects, changes over time and space, and other issues described in detail in the paper. The important point, though, is that for each demographic group, the authors were able to compare how monetary policy affected that group’s employment growth in tight as compared to slack labor markets.

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The authors' empirical review revealed the following findings:

- A one standard deviation drop in the federal funds rate in tight labor markets increases subsequent two-year Black employment growth by 0.91 percentage points, women's employment by 0.39 percentage points, and 0.37 percentage points for workers who did not complete high school.
- This additional impact of monetary policy in tight labor markets is sizable, corresponding to 9% and 18% of the mean employment growth rates for Blacks and high school non-completers over the sample period, respectively.
- Monetary policy's incremental effects on less-attached workers' employment growth in tight labor markets holds over time, peaking 7 to 9 quarters after interest rates decrease. (See Figure 2.)
- Finally, these effects are muted or non-existent for groups with stronger labor market attachment. For example, the point estimate for White employment growth is less than one quarter of the estimate for Blacks and not statistically significant.

The authors also test these findings against an economic model to analyze how monetary policy affects different parts of the labor market. In the model (New Keynesian with heterogeneous

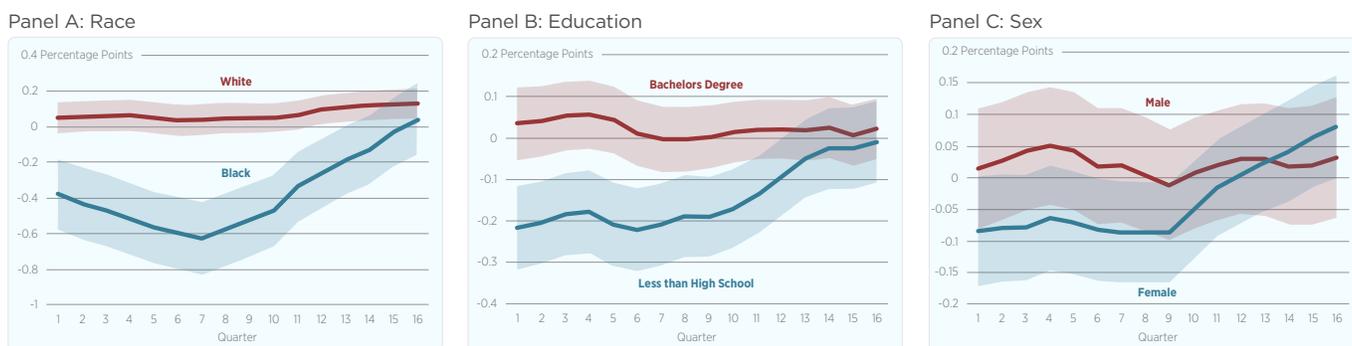
workers), worker types are differentiated by their productivity level. Again, the paper provides a detailed explanation of the model and its parameters, but in brief this theoretical exercise reveals that expansionary monetary policy lowers hiring and firing thresholds and results in greater employment, particularly among workers with lower average employment levels.

Further, the model shows that the expansionary effect of monetary policy on the employment of least-attached workers is stronger in tighter labor markets. Two forces drive this result. First, in tighter labor markets, marginal workers have lower productivity; and second, employment expands more easily because screening for lower productivity workers is less costly. Higher productivity workers also benefit from monetary expansions, but less so, and their employment is less sensitive to labor market tightness.

Conclusion

The authors employ a first-of-its-kind empirical analysis of nearly 900 local labor markets, buttressed by a theoretical model, to shed light on one of monetary policy's enduring challenges: How to use monetary policy to increase employment among targeted demographic groups. Their work presents good news and, if not bad news, then certainly challenging news for monetary policymakers. The good news is that monetary policy is not as blunt a policy instrument as formerly understood—it can raise the employment levels of communities that are not as firmly

Figure 2 • Impact of Monetary Policy on Employment Growth Over a One-Year Horizon
One-year horizon starts at different time periods following monetary policy rate change



Note: This figure depicts the temporal dynamics of the differential impact of monetary policy on employment growth in tight versus slack labor markets. The figure shows the impact of monetary policy over a one-year horizon starting in different quarters following the monetary policy rate change for different demographic groups within three categories: race (Panel A), education (Panel B), and sex (Panel C). For each quarter, beginning one quarter to 16 quarters out, the figure plots the coefficient on the interaction term between the federal funds rate and the local prime age employment-to-population ratio in equation (4). Shaded areas present one standard deviation confidence intervals.

attached to the labor market, like women, Blacks, and the least educated. The challenging news is that these positive effects occur when labor markets are already tight and when policymakers would typically start to worry about the effects of monetary expansion on inflation.

These findings suggest that if Federal Reserve policymakers do indeed plan to view maximum employment as “broad-based and inclusive,” then they have their work cut out for them. Barring future work that reveals new insights, this research demonstrates that policymakers must manage tradeoffs between broad-based employment goals and inflation targets.

CLOSING TAKEAWAY

A one standard deviation drop in the federal funds rate in tight labor markets increases subsequent two-year Black employment growth by 0.91 percentage points, women’s employment by 0.39 percentage points, and 0.37 percentage points for workers who did not complete high school.

READ THE WORKING PAPER

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