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Estimating the effects of disinflationary monetary policy on minorities

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Abstract

There are solid theoretical reasons, based on concepts such as "ladder effects", to believe that disinflationary monetary policy disproportionately burdens low-income individuals. Minority groups in the U.S. tend to have lower incomes than whites. An implication of this wage gap is that the burden of contractionary monetary policy should fall on minorities. This paper uses identified vector autoregressions (VARs), narrative evidence, and the Romer and Romer [Romer, C., & Romer, D. (1989). Does monetary policy matters? A new test in the spirit of Friedman and Schwartz. *NBER Macroeconomic Annual*, *4*, 121–170.] approach to investigate whether this is so. The results indicate that disinflationary monetary policy increases unemployment among minorities approximately twice as much as it does among whites. The Federal Reserve (Fed) should take account of these effects when considering implementing disinflationary policy. © 2001 Society for Policy Modeling. Published by Elsevier Science Inc.

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1. Introduction

Most economists agree that in the short run, monetary policy can be an important source of economic fluctuations.[1] As Bernanke and Gertler (1995)

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[1] The May 1997 *American Economic Review* (pp. 230–246) contains articles by a panel of distinguished macroeconomists addressing the question of whether there is a practical core of

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discuss, this belief is supported by the vector autoregression (VAR) evidence of Bernanke and Blinder (1992) and Christiano, Eichenbaum, and Evans (1996), the narrative study of Friedman and Schwartz (1963), and the evidence from disinflationary periods presented in Romer and Romer (1989). One aspect of monetary policy that warrants further study is the distributional effects of disinflationary policy. As the *Economic Report of the President* (Executive Office of the President, 1997, p. 53) states, these effects are not widely recognized.

In theory, contractionary monetary policy should impact especially low-income individuals. Blanchard (1995) argues that an adverse aggregate demand shock such as a monetary contraction will exert "ladder effects", harming those on lower rungs of the occupational ladder more than those on higher rungs. Blanchard and Katz (1997) further argue that unskilled workers have much larger labor supply elasticities than skilled workers. A decrease in the demand for labor due to a recession will not decrease employment among skilled workers much, but will decrease employment among unskilled workers substantially. Thus, low-skilled, low-income individuals should suffer more from disinflationary policy.

It is well known that African–Americans and Hispanic–Americans tend to have lower incomes than whites (see, e.g., Bound & Freeman, 1992). The reasons for this wage gap are less clear. As Card and Lemieux (1994) discuss, it could reflect factors such as discrimination, productivity differences, or differential access to job information. The implication of the wage gap for monetary policy, however, is clear. The brunt of contractionary monetary policy should fall on blacks and other minorities earning lower wages rather than on whites.

This paper examines a variety of evidence to investigate whether this is so. As discussed above, evidence that monetary policy matters comes from the identified VAR methodology of Bernanke and Blinder (1992) and Christiano et al. (1996), the narrative approach of Friedman and Schwartz (1963), and the investigation of disinflationary periods by Romer and Romer (1989). Monetary policy shocks are identified in this paper using all three approaches. The effect of disinflationary policy measured in these three ways on unemployment disaggregated by race is then examined.

The results indicate that blacks and Hispanics bear a disproportionate burden from disinflationary policy. Impulse–response functions from a VAR indicate that positive innovations in the federal funds rate increase unemployment among blacks and Hispanics by 50–90% more than among whites. Examination of historical episodes of disinflationary policy shows that unemployment among minorities increases almost twice as much as among whites. Estimation using the Romer dates reveals that anti-inflationary policy shocks increase unemployment among non-

[1] *(continued)* macroeconomics that we should all believe. All the panel members agreed that one element of the core is the proposition that in the short run, monetary policy can affect the real economy. The panel members were Olivier Blanchard, Alan Blinder, Martin Eichenbaum, Robert Solow, and John Taylor.