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Tight labor markets are essential to reducing racial disparities and within the purview of the Fed's dual mandate

Blog • By Valerie Wilson • May 10, 2024

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This essay was originally published in the Point/Counterpoint section of the *Journal of Policy Analysis and Management* and can be accessed at https://doi.org/10.1002/pam.22545.

Key findings

- Growing evidence shows that monetary policy decisions have a measurable impact on racial disparities in the labor market. This evidence challenges long-held beliefs about the purview of the Federal Reserve ("the Fed")'s mandate and the limits of macroeconomic policy. These findings deserve serious consideration as the Fed begins review of its monetary policy framework.
- Monetary policy decisions can help sustain tight labor markets, which can significantly reduce the Black unemployment rate and narrow the Black-white unemployment rate gap.
- In addition, tight labor markets have great potential to reduce racial wage inequality by boosting bargaining power and supporting faster wage growth for Black and low-wage workers.
- In recent years, tight labor markets have facilitated greater racial equity and increased economic security for Black Americans without triggering a corresponding spike in inflation.

How to fix it

Proposals to make racial equity a more explicit consideration of the Fed include having Congress require the Fed chair to report on racial gaps in employment and wages, and the actions being taken to reduce them. The Fed can also center equity by engaging in research on the causes of the racial gaps.

Racial disparities in unemployment are a defining feature of the U.S. labor market. Since the U.S. Bureau of Labor Statistics (BLS) began reporting a Black unemployment rate in 1972, it has consistently been about double the white unemployment rate. On average, since unemployment rates decline with increasing levels of education, racial disparities in unemployment have commonly been attributed to observed racial differences in educational attainment or skills. However, the persistent 2-to-1 Black-white unemployment ratio is largely unexplained by observable factors like education or skills. In fact, the 2-to-1 ratio between Black and white unemployment rates exists at each level of education,

across age cohorts, and for men and women, suggesting that broader structural factors, including racial discrimination and unequal bargaining power, lie at the root of persistent inequality in labor market outcomes between Black and white Americans.

The persistence of the Black-white disparity in unemployment makes it an ideal target for equity-focused policymaking. However, the idea that the unemployment rate gap is largely the result of a Black-white human capital gap has dominated decisions about the appropriate policy levers for closing the gap. As a result, most interventions focus on individual acquisition of additional skills or education rather than removing structural barriers to more equitable outcomes. This human capital-centered approach also undergirds the long-standing view that narrowing racial disparities in unemployment is outside the purview of the Federal Reserve ("the Fed")'s legal mandate to maximize employment while maintaining price stability.

Adjusting short-term interest rates is the primary tool the Fed uses to manage this dual mandate. When the Fed lowers interest rates, it increases economywide spending and aggregate demand. This in turn raises employment (and lowers unemployment) as firms hire more workers to meet growing demand. As demand and employment continue to rise, so can the risk of inflation, motivating the Fed to raise interest rates to dampen demand. As demand falls, employment falls (and unemployment rises).

While the Fed's monetary policy tools are not sufficient to fully address all of the structural factors at the root of the Black-white unemployment rate gap, the consistency of the 2-to-1 Black-white unemployment ratio means monetary policy decisions have predictable implications for the level of unemployment experienced by Black Americans and white Americans. There is also growing evidence that monetary policy decisions that sustain tight or high-pressure labor markets can significantly reduce the Black-white unemployment rate gap.

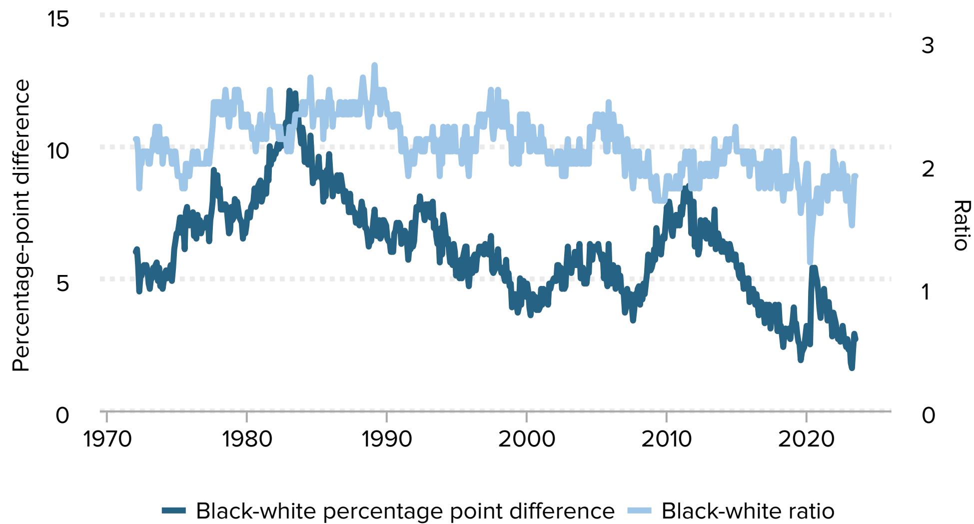
Figure 1 presents the Black-white unemployment rate ratio (measured along the right y-axis) and the difference between the Black and white unemployment rates (measured along the left y-axis) between 1972 and 2023. Historically, the Black-white unemployment ratio has changed very little with fluctuations in the business cycle. However, the ratio has gradually trended downward in recent years, more often falling just under 2 to 1 since 2018, compared with previous decades when the ratio was more often at or above 2 to 1. The most notable changes in the gap are measured by the percentage point difference between the Black and white unemployment rates, which narrows considerably in tighter labor markets.

Slack labor markets sustain needlessly high Black unemployment

In recent decades, genuinely tight labor markets have been rare, consigning Black Americans to chronically high unemployment. Given this relationship, centering equity would require that the Fed prioritize, or at least give considerable weight to, maximizing employment when setting the nation's monetary policy. Yet genuinely tight labor markets have been rare for most of the last 5 decades. Between 1972 and 2019, the actual

Figure 1

Monthly Black-white unemployment rate ratio and Black-white percentage point difference in employment rates, 1972–2023



Sources: Author analysis of U.S. Bureau of Labor Statistics Current Population Survey, Monthly Unemployed Rate by Race and Ethnicity data series LNS14000003 and LNS14000006, retrieved from FRED.

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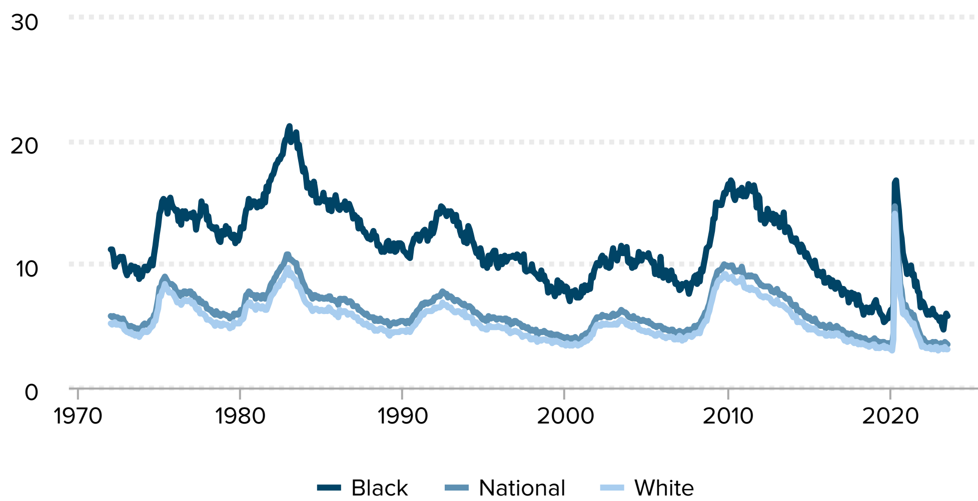
unemployment rate averaged 6.2%, which is 0.7 percentage points higher than the average Congressional Budget Office estimates of the natural rate of unemployment (5.5%) over that period. The natural rate of unemployment is also referred to as the non-accelerating inflation rate of unemployment (NAIRU)—a conservative approximation of the lowest level of unemployment that can be sustained while maintaining price stability.

By this standard, the Fed has arguably erred on the side of allowing more labor market slack to keep inflationary pressures down. This has not only resulted in higher than necessary national rates of unemployment but has needlessly consigned Black workers to much higher rates of unemployment. For example, when Chair Paul Volcker aggressively sought to reduce inflation between 1980 and 1983, the national unemployment rate rose to over 10% while the Black unemployment rate peaked at over 20%, as shown in **Figure 2**. By contrast, the highest monthly white unemployment rate during that time was 9.7% according to the Current Population Survey.

Between 1972 and 2019, the Black unemployment rate had never fallen below 6% until a brief 6 months in 2019, just months before the pandemic-triggered recession in the first half of 2020. In the subsequent economic recovery, the Black unemployment rate dipped below 6% again in April 2022, and has averaged 5.7% between April 2022 and July 2023. Since 2019, the Black-white unemployment rate gap (percentage point difference between Black and white unemployment rates) has also reached historic lows (See Figure 2).

Figure 2

National, Black, and white (monthly) unemployment rates, 1972–2023



Source: U.S. Bureau of Labor Statistics Current Population Survey, Monthly Unemployed Rate by Race and Ethnicity data series LNS14000000, LNS14000003 and LNS14000006, retrieved from FRED.

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The historic result of the Fed's response to the Great Recession

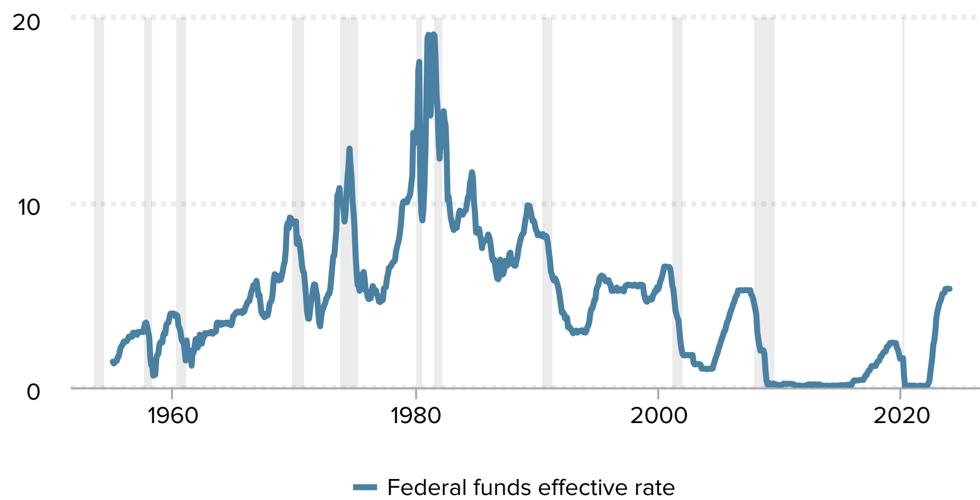
The Fed's extraordinary and unprecedented measures in response to the Great Recession tested the limits of monetary policy, yielding the historically low rates of Black unemployment and the accompanying record-low Black-white unemployment rate gap. As shown in **Figure 3**, for nearly seven consecutive years, between January 2009 and December 2015, the Federal Open Market Committee (FOMC) maintained a near-zero federal funds effective rate (below 0.25%). Rates remained under 2.5% through October 2022—registering almost 14 consecutive years of interest rates at or below that level—when the FOMC began enacting more aggressive interest rate hikes in an effort to bring down stubbornly high rates of inflation related to the pandemic. This marked change—from a Federal Reserve that tolerated more labor market slack to one that was willing to push the limits of maximum unemployment by targeting a near-zero federal funds rate for several years following the Great Recession—reduced the Black-white unemployment rate gap to an annual average of less than 3 percentage points in 2019 for the first time on record.

Tight labor markets and the reduction of Black-white labor market disparities

Research confirms the benefits of tight labor markets for reducing Black-white labor

Figure 3

Federal funds effective rate, 1955–2023



Source: Board of Governors of the Federal Reserve System (US), Federal Funds Effective Rate [FEDFUNDS], retrieved from FRED.

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market disparities. Empirical studies examining the relationship between tight labor markets and Black-white unemployment rate gaps support these observations. One study demonstrated that the primary mechanism for this narrowing of the Black-white unemployment rate gap is indeed a greater responsiveness of Black unemployment to macroeconomic forces. In other words, when the national (or white) unemployment rate changes by 1 percentage point, the Black unemployment rate changes by more than 1 percentage point. Utilizing data for 1975 to 2018, the authors found evidence suggesting that as strong labor markets tighten further, the improvements in racial disparities get incrementally greater. Moreover, as the unemployment rate moved below the Congressional Budget Office's natural rate, the unemployment rates of the most marginalized groups experienced the greatest improvements. For example, unemployment rates of young Black Americans, ages 16 to 24, were more responsive to further labor market tightening than those of young white Americans and older Black Americans (ages 25 to 64). Unemployment rates of young Black Americans are consistently at least twice as high as those of young white Americans and older Black Americans.

Another study concluded that as the labor market recovery from the Great Recession continued to move forward (2016 was the latest data year in this analysis), the recovery contributed substantially to reducing the unemployment gaps that had widened dramatically during the Great Recession. Additionally, the authors found that the relatively higher risk of job loss among Black Americans compared with white Americans was the biggest driver of racial unemployment gaps and the differential cyclicality of unemployment. Based on this finding, an extended period of labor market tightness is actually essential to the recovery of job losses among Black Americans as well as reducing

the Black-white unemployment rate gap. The authors also found evidence that among women, the portion of the Black-white gap unexplained by observable factors declined from more than 6 percentage points in 1976 to about 3 percentage points in 2016, with most of the decline occurring in the very tight labor markets of the 1990s. Given the authors' related finding that the majority of the Black-white unemployment gap is unexplained by observable factors, one might interpret this result as an indication that tight labor markets can effectively limit the extent of racial labor market discrimination—a structural barrier to employment—experienced by Black women.

In addition to reducing racial disparities in unemployment, tight or high-pressure labor markets also support faster wage growth for Black and low-wage workers . Tight labor markets help to boost the bargaining power of the most marginalized workers because at lower rates of unemployment, employers face greater competition for workers. This gives workers increased leverage to either move to a higher paying job or negotiate for higher wages in their current job. As a result, high-pressure labor markets also hold great potential to reduce racial wage inequality.

Another author presented counterfactual trends in the Black-white wage gap for 1973 to 2019 under less contractionary monetary scenarios than those that prevailed using the estimated coefficients on the responsiveness of the median hourly wages of Black and white workers to the unemployment rate. Specifically, if unemployment had averaged 2 percentage points less between 1973 and 2019, 80% of the median Black-white wage gap that appeared in 1973 could have been erased (shrinking from 28.6% to 5.4%). With unemployment averaging just 1 percentage point less, the median wage gap could have *fallen* slightly (to 18.0%) rather than rising by almost 8 percentage points over this period.

The gap-narrowing power of high-pressure labor markets is amplified even more when looking at median *annual* earnings, which are affected through higher hourly wages as well as increased hours worked during the year. The same study reported that if the unemployment rate had averaged 1 to 2 percentage points lower after 1973, the Black-white annual earnings ratio would be over 90% or essentially 1, respectively. It's important to recognize that the benefits of increased annual earnings extend beyond the individual worker, contributing to higher household income and reduced poverty for both the worker and their dependents.

Evidence of the immense potential for tight labor markets to facilitate greater racial equity and increased economic security for Black Americans is compelling. Still, it is important to acknowledge that tight labor markets can pose a risk to price stability. Here, as well, the record suggests that these risks are no longer as high as perhaps they may have been in the past. Though inflation has been unacceptably and stubbornly high during the recent period of post-pandemic labor market tightening, the Fed has not attributed this to an overheated labor market. Rather, in public statements, the FOMC acknowledges that most of the spike in inflation was caused by supply and demand imbalances related to the pandemic (namely shift in consumer demand for durable goods and supply chain bottlenecks) with added pressures from the war in Ukraine and COVID-19-related shutdowns in China. Additionally, inflation was consistently below the Fed's target for most of the six years preceding the pandemic, and remained stable even as the unemployment

rate fell below estimates of the NAIRU, consistent with an apparent flattening of the Phillips curve. When unemployment declined to about 4% in the late 1990s, and even below 4% in 2018 to 2019, there was no marked uptick in wage or price inflation requiring the Fed to slow demand growth.

Recommendations for how the Fed can actively center equity

Together, these outcomes suggest more room for flexibility in the Fed's policymaking targets and goals, a point that has not gone unnoticed by Federal Reserve leadership. Janet Yellen, the previous Federal Reserve Board chair, led a shift to a more data-dependent Fed, signaling a more statistics-driven wait-and-see approach to macroeconomic policymaking over fixed targets and predictions. Arguably, this shift contributed to decisions to keep interest rates near 0% for almost seven years. It also laid the groundwork for the Fed's new monetary policy framework, introduced in August 2020 by the current Federal Reserve Board Chair, Jerome Powell. Under the new framework, maximum employment is "a broad-based and inclusive goal that is not directly measurable and changes over time." While this framework falls short of explicitly centering equity as a goal, it allows for greater flexibility in assessing maximum employment using a wide range of indicators rather than specifying a fixed target.

Powell's statements before Congress have gone further in acknowledging the significance of Federal Reserve decisions for specific racial and ethnic groups, different communities across the country, and low-wage workers rather than the overall macro economy. But there is room for the Fed to go further in establishing a path to greater racial equity in the labor market. The potential to close racial disparities in the labor market should be considered a substantial benefit in FOMC deliberations when weighed against the risk of inflation. Moreover, testing the limits of maximum sustainable employment provides policymakers at the Fed and in Congress with better information about what else should be done to close persistent racial gaps. When unemployment is low, presumably those who remain unemployed are either in transition between one labor force status to another (i.e., entering the labor market or between jobs) or face specific barriers to employment that need to be addressed through more targeted interventions.

Some have recommended a path to making equity a more explicit consideration by proposing that Congress require the Fed chair to report on racial employment and wage gaps, as well as what the Fed is doing to reduce them, in their spoken and written testimony. Other suggestions include that the Fed make use of other tools in addition to interest rate policy to establish and center equity goals. These tools consist of engaging in research on the causes of the racial gaps, as well as tracking economic stability among vulnerable families and access to affordable capital, including housing, in disinvested communities.