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Monetary Policy Rules and the Inequality-Augmented Phillips Curve

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Monetary policy is expected to control inflation through channels that affect aggregate demand and, consequently, the unemployment rate. Based on the traditional Phillips curve, it is argued that a lower inflation rate is associated with higher unemployment rates. In this work, we show that monetary policy also has implications for the income and wage inequalities since higher unemployment reduces the bargaining power of the working class as a whole and, to a larger extent, that of low-wage workers who are more exposed to business cycle fluctuations.

The analysis is undertaken in a stock-and-flow consistent agent-based model in which inflation and inequality result from the social conflict over income distribution between workers and firms, which is nonetheless mediated by monetary policy. More specifically, we extend the model presented in Rolim et al. (2021) by incorporating an explicit monetary policy rule and adding emulation consumption and household debt as additional channels through which monetary policy affects aggregate income (together with firms' debt).

Our baseline scenario explores the inflation-inequality-unemployment nexus, which leads to the emergence of the inequality-augmented Phillips curve relating higher levels of inequality to lower inflation rates. This results from the well-documented positive relation between unemployment rates and inequality and from the larger exposure of low-wage workers to business cycle fluctuations, which makes their wage growth rate more sensitive to cyclical fluctuations.

We then perform two sets of experiments to further investigate the implications of this nexus. The first experiment shows that the worsening of low-wage workers’ bargaining power leads to two important phenomena: the flattening of the Phillips curve and the increase in income and wage inequalities. Indeed, the reduction of low-wage workers' bargaining power has reduced the sensitivity of nominal wage adjustments (and inflation) to changes in the unemployment rate, while at the same time increasing the wage disparities among workers.

The second experiment contrasts different monetary policy rules and compares the implications for the inequality dynamics. In line with the inequality-augmented Phillips curve, the rules have important implications for wage and income inequalities: a monetary policy rule that prioritizes low inflation rates is associated with higher unemployment and higher inequality levels.

In sum, our results shed new light on the inflation-inequality-unemployment nexus and explore it to explain important phenomena observed recently in countries such as the USA and derive some useful insights into monetary policy management.