

Review Article

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The Long-Term Impacts of Federal Reserve Interest Rate Hikes on Income Inequality

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ABSTRACT

This paper investigates the effects of Federal Reserve interest rate hikes on income and wealth inequality in the United States. We examine the short-term and long-term distributional consequences of monetary tightening, emphasizing the channels through which policy actions influence labor markets, asset values, credit access, and housing affordability. Higher interest rates slow investment and hiring, disproportionately affecting low-income workers in cyclical sectors and amplifying short-term income inequality. Similarly, rising borrowing costs and mortgage rates constrain homeownership and wealth accumulation for younger and minority households.

Conversely, rate hikes mitigate long-term inequality by curbing inflation, preserving real wages, and preventing destabilizing price surges that disproportionately burden low-income families. We analyze historical episodes, including the Volcker era, the 2015-2018 gradual tightening, and post-COVID hikes and compare cross-country evidence on the distributional impacts of monetary policy. Our findings highlight the dual role of interest rate policy: short-term exacerbation of inequality versus long-term protection of purchasing power. Policymakers should consider complementary fiscal measures, such as targeted subsidies, housing assistance, and wage support, to alleviate short-term inequities while achieving inflation stabilization. By integrating historical, empirical, and contemporary evidence, this study offers a comprehensive assessment of how monetary policy interacts with structural inequality in modern economies.

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Introduction

Over recent years, the Federal Reserve has applied its most aggressive series of interest increases since the early 1980s. These actions, taken to fight inflation after the pandemic, have provoked analyses not just of their effectiveness in stabilizing costs but also of their broader social implications. Among the most pressing concerns is that of monetary policy's effectiveness with regard to inequality. The Fed has a dual mandate of ensuring maximum employment and price stability. Inequality is never mentioned in such a mandate, but monetary tightening has a differential effect on different portions of the American people [1].

This work argues that increases in interest rates by the Federal Reserve, while necessary for long-run price stability, would in the short run heighten income and wealth inequalities owing to shocks in the labor market, difficulties with respect to affordability of residences, and restricted access to credit products. In the long run, however, through control of inflation and protection of real wages, such increases in rates might mitigate some of the pressures accompanying inequality [2,3].

Monetary tightening overall has a wide impact that largely depends upon structural factors, precedented history and prevalence of accommodating fiscals [4].

Gini Coefficient

To measure inequality across the episodes in this paper, I use the Gini coefficient, a standard measure of how evenly income is distributed. It ranges from 0 (perfect equality) to 1 (one household holds all income). It is calculated as:

$$G = \frac{\sum_{i=1}^n \sum_{j=1}^n |x_i - x_j|}{2n^2\mu}$$

where x_i and x_j represent individual incomes, n is the population size, and μ is the mean income. This formulation captures the average difference between all pairs of incomes relative to the mean. In this paper, higher Gini values indicate greater concentration of income and thus higher inequality.

This paper uses the Census Bureau's household Gini index, which is based on pretax money income [5]. Because it measures income before taxes and transfers, it captures labor market effects well but misses changes in wealth, which Section IV covers separately. The Census also changed its survey methods in 1993, so this paper compares changes *within* each episode rather than levels across decades.

Background

The Federal Reserve influences the U.S. economy primarily through its control of short-term interest rates. By raising or

lowering the federal funds rate, it directly affects borrowing costs for households and businesses, investment decisions, and overall economic growth. Higher rates typically cool consumer demand and business expansion, whereas lower rates stimulate borrowing and spending [6,7].

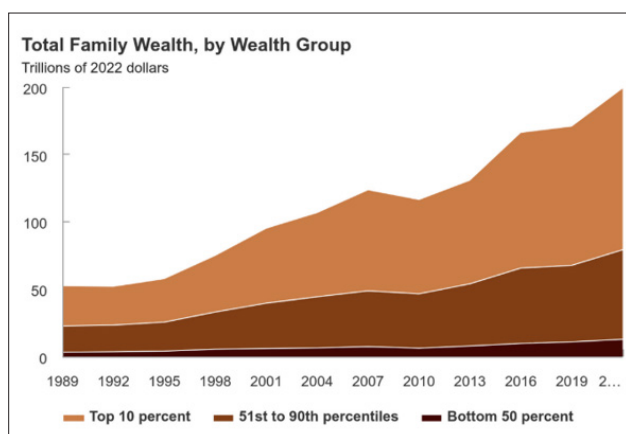


Figure: 1.1

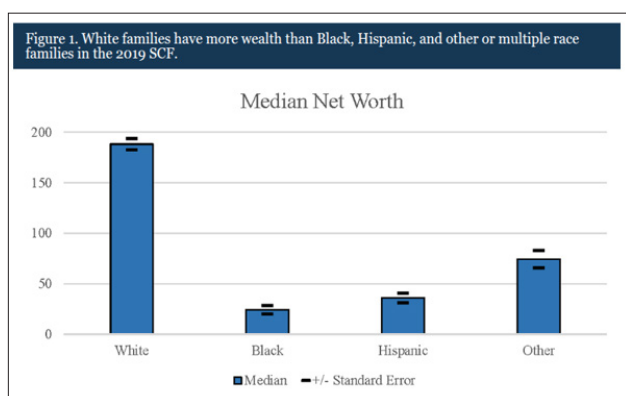


Figure: 1.2

Income and wealth inequalities in the United States are both strong and persistent. Figure 1.1 from the Congressional Budget office in 2024 tells shows us that roughly 70% of the country's wealth is concentrated among the top 10% of households, while Figure 1.2 shows that median wealth of Black and Hispanic households contains less than 15% of white household wealth [8]. These disparities together demonstrate that changes to monetary policy would differentially affect groups already disadvantaged. Monetary policy's distributional impacts for this country are evaluated in this paper by examining how changes in interest rates impact wages, employment, access to credit, and asset prices.

Mechanisms Connecting Rate Increases to Inequality Labor Market Effects

Higher interest rates raise borrowing costs for businesses, slowing expansion and potentially increasing layoffs. Low-income workers, who disproportionately work in cyclical sectors such as construction, manufacturing, and retail, are the most vulnerable [1,9]. During the Volcker era (1979-1983), unemployment surged to 10% as rates exceeded 15% to combat inflation. Job losses were concentrated among blue-collar and minority workers, exacerbating income inequality [10].

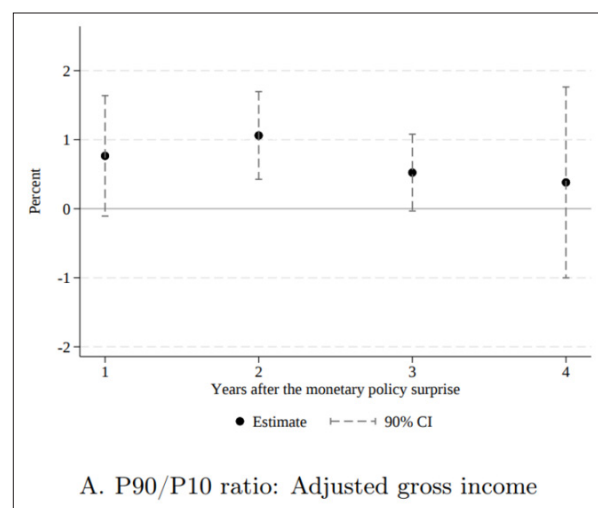


Figure: 1.3

Even within contemporary economic cycles, the repercussions remain evident. Particularly, empirical research evaluating individual income tax return information and wage distributions from 2022 to 2024 demonstrates that unexpected increases in Federal Reserve interest rates prompted more substantial declines in real income at the lower segment of the wage distribution in comparison to the upper segment. In particular, Figure 1.2 depicts the ratio of wages between the 90th and 10th percentiles. Analysis of these ratios show that they rose by roughly one percentage point within a timeframe of two to four years following monetary tightening, signifying a notable expansion of wage inequality. These effects are especially amplified in urban regions characterized by weaker labor markets, where low-income workers experience greater employment and wage reductions relative to their higher-earning counterparts [11].

Additional microdata analysis makes it possible to deduce that not only do work hours of low-paid workers diminish with contractionary monetary policy, but also their wage mobility is restricted, thereby affirming income inequalities.

Asset Price Impacts

Rate increases affect asset values, such as stocks, bonds, and real estate. Higher-income families maintain more diversified portfolios and are better equipped to absorb temporary losses, while low-income families depend mostly on wages [6,12]. For that reason, even though losses of asset values might sound like they decrease inequality on a sheet of paper, in reality, worst hits go to people with no large financial buffers [13].

This argument holds on paper but is weaker in practice for three reasons. First, asset losses for wealthy households are usually temporary. U.S. stocks fell sharply in 2022 but returned to record highs by early 2024, so households that could afford to wait lost little. Job losses and missed wage growth for low-income workers are not recovered the same way. Second, higher rates also raise the returns on savings accounts, bonds, and money market funds, and those gains go mostly to households that already have savings. Third, a lower-income household with no financial cushion feels a rate hike through its paycheck and borrowing costs, not its portfolio. A temporary drop in measured wealth at the top does not offset a lasting loss of income at the bottom. Over time, keeping inflation under control may also prevent asset bubbles whose collapse would hurt vulnerable households most [2]. In the short run, though, the asset channel narrows inequality only on paper,

while the labor and credit channels widen it in reality.

Credit and Housing Access

Housing is the most prevalent asset class for middle-income families. Higher interest rates raise mortgage payments and limit opportunity for homeownership. In 2023 and 2024, mortgage rates hit just over seven percent, marking a forty-year low for affordability, hurting first-time Homebuyers and families of color most of all [14].

Limited access to credit also widens inequalities. Poor families that are often subjected to variable-rate loans, payday loans, or restricted credit products are further spun into financial distress with increases in interest rates [1]. Rising rates do not just slow down wealth buildup but also enhance inter-generational inequality [3].

Inflation Control as a Counterbalance

While rate hikes impose short-term costs, they serve to stabilize inflation, protecting the real purchasing power of wages [2]. Inflation disproportionately affects low-income households, which spend a larger share of income on essentials such as food, energy, and housing. The Fed's actions reduced inflation from over 9% in 2022 to roughly 3% in 2024 mitigating the long-term erosion of purchasing power [15].

Nevertheless, data from recent years indicate that throughout this period of elevated inflation, households with low-income experienced inflation rates surpassing those of higher-income groups by around 0.7 percentage points, resulting in a significant burden and exacerbating real income inequality [16].

Historical Case Studies

The Volcker Era (1979-1983)

Paul Volcker, as the Chairman of the Federal Reserve during the late 1970s and early 1980s, is renowned for his aggressive monetary tightening to combat the rampant inflation that plagued the U.S. economy. His policy involved significant hikes in interest rates, which successfully curbed inflation but also led to a recession [17]. The reduction in inflation was achieved through a credibility-building approach that shifted expectations around monetary policy, stabilizing prices and long-term economic conditions. However, the immediate economic outcomes, characterized by increased unemployment and a recession, had significant distributional consequences. The high interest rates led to a downturn in economic activity, impacting sectors reliant on borrowing most acutely. This resulted in job losses and wage stagnation, particularly affecting lower-income workers more than higher-income earners [18]. The direct consequences of higher unemployment and slower wage growth exacerbated income distribution disparities. In particular, income and consumption inequality saw cyclical variations linked to these monetary shocks. The contractionary nature of the policies led to more pronounced inequality as lower-income households typically have less financial resilience against economic shocks [18].

Gradual Tightening (2015-2018)

Transitioning to Janet Yellen's tenure, her approach was characterized by a cautious and data-dependent strategy. Yellen focused on achieving maximum employment while ensuring price stability, thereby maneuvering through a recovering economy post the 2008 financial crisis [19]. Jerome Powell, succeeding Yellen, initially continued this approach but later navigated the economic complexities introduced by the COVID-19 pandemic. Powell's term saw a historic dovish pivot with unprecedented monetary accom-

modation, involving slashing of interest rates and large-scale asset purchases to support the economy during the pandemic-induced downturn [20].

Post-COVID Increases (2022-2024)

The COVID-19 pandemic's initial response saw central banks around the world, including the Fed under Powell, drastically reducing interest rates to near-zero levels and engaging in quantitative easing to stabilize financial markets. These measures were aimed at providing liquidity and maintaining flexible financial conditions amid the economic disruption [21]. As the economy began to recover, concerns about inflationary pressures led to a shift towards tightening monetary policy, though the timing and magnitude of these hikes were contentious, reflecting a complex balance between sustaining recovery and controlling rising inflation.

Episode	Start	End	Change
Volcker (1979–1983)	0.404	0.414	+0.010
Gradual (2015–2018)	0.479	0.486	+0.007
Post-COVID (2021–2024)	0.494	0.489	−0.005

Inequality rose during the first two episodes and fell during the third. The Volcker increase is the largest, which fits the severe job losses of the early 1980s. However, the Gini kept climbing through the rest of the decade, so factors beyond monetary policy were also at work. The post-COVID decline complicates this paper's argument. The Census Bureau attributes the 2022 drop mainly to falling real incomes at the middle and top of the distribution [22].

Low-income households held up comparatively well, likely because the labor market stayed tight even as rates rose. This suggests the metro-level wage effects described in Section IV did not translate into higher national household inequality, at least in the short run.

Following these findings, recent Federal Reserve empirical studies confirm that rate increases after the pandemic widened wage inequality, heavily hitting the lowest wage deciles with real losses in income and fewer working hours. The P90/P10 wage ratio increased by around one percentage point across most metropolitan regions after two to four years of rate increases, affirming heightened income inequality pushed by monetary contraction [11].

Long-Term Implications

Over the long term, interest rate increases yield mixed outcomes. While reduced homeownership rates and constricted access to business credit would potentially widen intergenerational and racial disparities in wealth, price stability fosters stable wage increases and economic security [4]. It all depends on the last of the distributional impacts upon

- **Speed and Size of Rate Increases:** steep increases raise short-run inequality and slow adjustments minimize hurt.
- **Structural Inequalities:** current differences either amplify or dampen impacts.
- **Complementary Macroeconomic Policies:** targeted subsidies, tax credits, and assistance with affordable housing can mitigate adverse effects [3,9].

Policy Discussion

Critics argue it falls outside the dual mandate and that a single interest rate can't be aimed at specific households. Supporters respond that ignoring who bears the cost of tightening threatens public trust in the Fed [23]. The Fed itself has gone back and forth. In 2020, it called maximum employment a "broad-based and inclusive goal" and stopped raising rates just because unemployment looked low. That approach arguably slowed its response to inflation in 2021 and forced the sharp hikes that followed, and in 2025 the Fed dropped the inclusive language [11].

Fiscal policy is better suited to the job. Targeted tax credits, rental assistance, and wage subsidies can protect vulnerable households without undercutting the Fed's inflation goals [4]. The catch is that Congress rarely acts quickly, and little targeted relief accompanied the 2022-2023 hikes. Within its mandate, the Fed can still limit the damage by tightening gradually and using forward guidance so households have time to adjust [12,24].

Conclusion

Federal Reserve interest rate hikes are a powerful but blunt instrument. Short-term impacts disproportionately harm low-income workers, first-time homebuyers, and credit-dependent households, while wealthier households withstand temporary asset losses more effectively [6,13]. Recent empirical findings derived from extensive wage and income datasets validate that the interest rate escalations occurring post-pandemic led to considerable declines in real income among low-wage workers, thereby exacerbating wage inequality in the impacted areas [11]. In the long run, increases in rates serve to protect real wages and stabilize the economy, thereby averting the diminishing purchasing power that results from rampant inflation [2,3]. The overarching effect on inequality is dependent on structural variables and the provision of fiscal support. While monetary policy by itself cannot rectify inequality, comprehending its distributional implications is crucial for formulating complementary policies that foster an inclusive and resilient economic environment.

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