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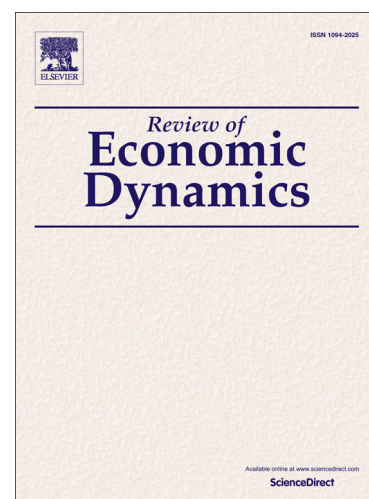
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Optimal Inflation to Reduce Inequality*

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Abstract

A popular argument in favour of price stability is that the inflation-tax burden would disproportionately fall on the poor because wealth is unevenly distributed and portfolio composition of poorer households is skewed towards a larger share of money holdings. We reconsider the issue in a DSGE model characterized by limited participation to the market for interest bearing assets (LAMP). We show that a combination of higher inflation and lower income taxes reduces inequality. When we calibrate the share of constrained agents to fit the wealth Gini index for the US, the optimal inflation rate is above 4%. This result is robust to alternative foundations of money demand equations.

Jel codes: E52, E58, J51, E24.

Keywords: inflation, monetary and fiscal policy, Ramsey plan, inequality.

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