

Exchange rate policy and income distribution in an open developing economy

Elisabetta Michetti, Domenica Tropeano

Abstract

In this work we are going to deal with the issue of the distribution of income in an open economy within a simplified macroeconomic model with constant prices. This type of model could apply to middle-income developing countries, which have succeeded in fighting inflation through a policy of high interest rates. It will be assumed that the implicit target of monetary policy now becomes the exchange rate and interest rates are set at a high level to lower the exchange rate (defined as the price of the foreign currency in terms of the domestic one). Even if this strategy may work it may produce negative effects on output growth and the distribution of income. The lowering of the exchange rate target would have the following effects on distribution. It would cause a reduction in the growth of output, it would lower the wage rate. Domestically-produced income distributed abroad should increase instead. The domestic interest rate would rise only for suitable small values of the parameter, which links imports to income. The effect on the profit share is indeed uncertain.

Elisabetta Michetti, Università degli Studi di Macerata.

E-mail: michetti@unimc.it.

Domenica Tropeano, Università degli Studi di Macerata.

E-mail: tropeano@unimc.it.