# Monetary Policy and Inequality: a Two-way Relation*

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**Abstract**

We study the transmission of monetary policy in the presence of heterogeneous households and examine the implications when the share of constrained households is a function of monetary policy. We build an analytically tractable heterogeneous agent New Keynesian (THANK) model with an endogenous share of hand-to-mouth households. This paper combines the THANK model of Bilbiie (2020) with an endogenous Markov switching process to capture the link between monetary policy shaping the tightness of financial conditions and the share of households living hand-to-mouth. Higher interest rates increase the tightness of financial conditions making it harder for saver households to stay unconstrained. Contractionary interest rate shocks increase income inequality and the number of households in financial distress. The transmission of monetary policy on aggregate demand is amplified in this setup by inequality between saver and hand-to-mouth households. The amplification effect depends on monopolistic rents (enhancing) and redistribution (mitigating). Additionally, we show that the implementation of an endogenous share of constrained households is neutral for the transmission of monetary policy in case of a THANK framework with steady state equality. Unlike most THANK models, we refrain from the assumption of a full insurance steady state and implement steady state inequality.

**Keywords:** Monetary Policy, Heterogeneous Households, Inequality, Aggregate Demand, Complementarity, Financial Conditions, Imperfect Insurance
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