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Financial Stability and Optimal Interest-Rate Policy

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Abstract

We study optimal interest-rate policy in a New Keynesian model in which the economy can experience financial crises and the probability of a crisis depends on credit conditions. The optimal adjustment to interest rates in response to credit conditions is (very) small in the model calibrated to match the historical relationship between credit conditions, output, inflation, and likelihood of financial crises. Given the imprecise estimates of key parameters, we also study optimal policy under parameter uncertainty. We find that Bayesian and robust central banks will respond more aggressively to financial instability when the probability and severity of financial crises are uncertain.

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