Financial Stability and Optimal Interest-Rate Policy

FEDS Working Paper No. 2016-67

72 Pages
Posted: 19 Aug 2016
Last revised: 21 Sep 2016

Andrea Ajello (https://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=1244079)
Board of Governors of the Federal Reserve System

Thomas Laubach (https://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=295164)
Board of Governors of the Federal Reserve System (deceased)

David Lopez-Salido (https://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=46044)
Board of Governors of the Federal Reserve System

Taisuke Nakata (https://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=2030600)
Board of Governors of the Federal Reserve System

Date Written: August, 2016

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.

JEL Classification: E43, E52, E58, G01

Download This Paper (Delivery.cfm/fedgfe2016-67.pdf?abstractid=2826404&mirid=1)

Open PDF in Browser (Delivery.cfm/fedgfe2016-67.pdf?abstractid=2826404&mirid=1&type=2)

28 References

1. D Aikman , A G Haldane , B D Nelson
Curbing the Credit Cycle
The Economic Journal , volume 125 , issue 585 , p. 1072 - 1109 Posted: 2015
Crossref (https://doi.org/10.1111/ecoj.12113)

2. G Barlevy
Policymaking under uncertainty: Gradualism and robustness
Economic Perspectives , volume 2 Posted: 2009

3. C Borio
The financial cycle and macroeconomics: What have we learnt?
Bank for International Settlements Working Papers Posted: 2012
Crossref (https://doi.org/10.1016/j.jbankfin.2013.07.031)

Uncertainty and the Effectiveness of Policy

American Economic Review , volume 57 , issue 2 , p. 411 - 436 Posted: 1967