The Response of Monetary Policy to Financial Distress

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December, 2008

Abstract

We develop a DSGE model with credit frictions along the lines of Kiyotaki and Moore (2008), enriched by number of nominal and real rigidities as in Christiano, Eichenbaum and Evans (2005) and Smets and Wouters (2007). We estimate the model with Bayesian methods for the post-Volcker period using both standard U.S. macroeconomic aggregates and measures of credit spreads. We use the estimated model to answer the following questions: 1) Historically, has monetary policy responded to measures of distress in credit markets? 2) Should monetary policy have responded? Specifically, we ask whether our estimates of the neutral rate, and hence our assessment of the monetary policy stance, change if we take into account credit market conditions. 3) In light of the model, is the rapid decline in the Fed Funds Rate in 2007-2008 justified by the recent turmoil in financial markets?

JEL CLASSIFICATION:

KEY WORDS: Monetary Policy, Credit Frictions, Bayesian Analysis

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