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# Optimal Monetary Policy Rules, Financial Amplification, and Uncertain Business Cycles

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## Abstract

This paper studies optimal monetary policy in the presence of ‘uncertainty’, time-variation in cross-sectional dispersion of firms’ productive performance. Using a model with financial market imperfections, the results suggest that (i) optimal policy is to dampen the strength of financial amplification by responding to uncertainty (at the expense of creating mild degree of fluctuations in inflation). (ii) Higher uncertainty makes the welfare-maximizing planner more willing to relax financial constraints. (iii) Credit spreads are a good proxy for uncertainty. Hence, a non-negligible response to credit spreads -together with a strong anti-inflationary policy stance- achieves the highest aggregate welfare possible.

*Keywords:* Optimal Monetary Policy, Financial Amplification, Uncertainty Shocks

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## 1. Introduction

While financial variables (e.g. credit spreads or asset prices) are with no doubt important ingredients for policy making, they have been conventionally argued to be useful in so far they help predicting inflation and real economic activity.<sup>1</sup> Introducing *uncertainty*, time-variation in cross-sectional dispersion of firms’ productive performance, alters the conventional wisdom: Optimal policy prescribes a *direct and systematic response* to credit spreads (above and beyond what inflation and output gap would imply). Such a policy dampens distortionary effects of uncertainty, and helps containing adverse feedback effects between financial conditions and the real economy.

Cross-sectional dispersion of firms’ performance has been emphasized in the recent literature as an important driver of business cycles.<sup>2</sup> I present in Figure 1 the evolution of dispersion against real GDP for the US economy (using macro- or micro-level measures). Leaving aside further empirical

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<sup>1</sup>See Cecchetti *et al.* (2000), Gilchrist and Leahy (2002), and Gilchrist, Yankov, and Zakrajsek (2009) for potential channels through which fluctuations in financial variables transmit into business cycles. The former two papers focus on asset prices, and the latter on corporate bond credit spreads.

<sup>2</sup>See Bloom (2009), Bloom *et al.* (2012), Bachmann and Bayer (2011), Chugh (2011), Basu and Bundick (2012), Arellano, Bai and Kehoe (2012), Gilchrist, Sim and Zakrajsek (2014), Christiano, Motto and Rostagno (2014), and references therein.

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