Optimal Monetary Policy under Risk of Sudden Stops

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Abstract

This paper studies benefits of optimal monetary policy in a small open economy with occasionally binding collateral constraint and nominal rigidity. We focus on a time-consistent policy equilibrium and compare this policy with others. There are mainly three findings. First, the characteristics of the optimal policy during crises is to cause currency appreciation and to give up price stability to some extent. Second, in tranquil times the optimal policy should maintain price stability. Third, monetary policies during crises affect the movement of economy in tranquil times. As a monetary authority encourages to mitigate the effect of crises, it reduces precautionary saving motive of domestic agents and increases frequency of crises. We also showthat the changes inworld interest rate strengthen incentives to borrow more in good times and increases magnitude of crises, but the optimal monetary policy can also mitigate this effect.

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