CIFREM SEMINARS

Credit Market Distortions, Asset Prices and Monetary Policy

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In this paper we develop a sticky price DSGE model to study the role of capital market imperfections for monetary policy implementation. Recent empirical and theoretical studies have stressed the effect of firms' external finance on their pricing decisions. The so-called cost channel of the transmission mechanism has been explored within New Keynesian frameworks that pose particular emphasis on inflation dynamics. These models generally disregard the role of external finance for the dynamics of asset prices. We ask whether monetary policy should respond to deviations of asset prices from their frictionless level and, more importantly, if the answer to this question changes when financial frictions are properly taken into account. We analyse these issues from the vantage of equilibrium determinacy and stability under adaptive learning. We show that usual conditions for equilibrium uniqueness and E-stability are significantly altered when the cost channel matters. Nevertheless, we find that responding to actual or expected asset price misalignments helps at restoring determinacy and stability under learning. These conclusions are further enforced in the presence of a high degree of pass-through from policy to bank lending rates.

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