Nominal debt dynamics and monetary policy

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Abstract

How is the impact of monetary policy affected by the nature of nominal debt contracts? How does this change if the interest payments on the debt are fixed or floating? To address these questions, we add a model of financial institutions’ behaviour to a dynamic general equilibrium model in which some households face credit constraints. We analyse the real effects of inflationary shocks, and derive implications for monetary policy. We question the common view that inflationary shocks necessarily result in debtors increasing their consumption. We also provide a potential explanation for interest rate smoothing on the part of central banks.

Keywords: nominal debt; dynamic general equilibrium, monetary policy.
JEL Classifications: E30, E44

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