Leaning against the credit cycle

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Abstract

We study how monetary policy and household debt interact when mortgages are amortized gradually. Slow amortization implies the empirically observed debt persistence and debt-to-GDP swings driven by output and inflation, rather than shifts in current borrowing. Interest hikes only weakly influence household debt, increasing debt-to-GDP in the short run, and reducing it in the medium run. Interest rate rules with a positive weight on the debt-to-GDP ratio induce equilibrium indeterminacy and greater volatility of debt itself. Relative to inflation targeting, leaning against debt-to-GDP swings calls for more expansionary policy when debt-to-GDP is high, and more contractive policy when debt-to-GDP is low.

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