Optimal Stabilization Policy with Flexible Prices

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Abstract
We construct a dynamic stochastic general equilibrium model to study optimal monetary stabilization policy. Prices are fully flexible and money is essential for trade. Our main result is that if the central bank pursues a long-run price path, thereby controlling inflation expectations, it can improve welfare by stabilizing short-run aggregate shocks. The optimal policy involves smoothing nominal interest rates which effectively smoothes consumption across states. Failure to follow a long-run price path makes any stabilization attempt ineffective.

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