LEANING AGAINST THE CREDIT CYCLE

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Abstract
How should a central bank act to stabilize the debt-to-GDP ratio? We show how the persistent nature of household debt shapes the answer to this question. In environments where households repay mortgages gradually, surprise interest hikes only weakly influence household debt, and tend to *increase* debt-to-GDP in the short run while reducing it in the medium run. Interest rate rules with a positive weight on debt-to-GDP cause indeterminacy. Compared to inflation targeting, debt-to-GDP stabilization calls for a more expansionary policy when debt-to-GDP is high, so as to deflate the debt burden through inflation and output growth. (JEL: E52, E32, E44)

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