Credit and Debt-Deflation: Key

1. False. For positive demand shocks, bigger shocks simply result in larger effects on inflation and output. For negative shocks, however, larger shocks may 1) induce a financial crisis where credit spreads start to have important adverse effects on output, and 2) a liquidity trap ensues where further monetary policy becomes ineffective. Doubling the negative demand shock may then have more than twice the effects on the economy. No such non-linearity exists for positive shocks.

2.In this model, deflation is more problematic than an inflation of equal magnitude. By setting $\bar{\pi} > 0$, a Central Bank provides itself with some cushion against deflation. It may then reduce the risk of financial crises. It also provides a greater cushion against possible liquidity traps.

3. True. Suppose, for example, that credit spreads depend only on inflation. Now suppose that a large and (usually) beneficial supply shock affects the economy so that $u_t < 0$. It is possible that this shock will result in enough deflation to induce a crisis. This scenario, however, is far less plausible than a demand induced crisis.

4. See #2.

5. Most of the time, including March 2005, credit spreads are small. The baseline New Keynesian Model is probably a decent description of the economy in these instances and it can be argued that the added complexity of adding credit spreads to the model is not worth it. In October 2008, however, credit spreads were very high and the baseline model was poorly equipped to explain the financial crisis.