Abstract

After the recent financial crisis of 2007, a connection between monetary policy and financial stability has started to be thoroughly investigated. One of the particular areas of this research field deals with the role of various financial variables in the monetary policy rules. The main purpose of this research is to find whether direct incorporation of the financial variables in the monetary policy rule can bring macroeconomic benefits in terms of lower volatility of inflation and output. So far, the main emphasis of the research has been placed on the investigation of the augmented Taylor rules in the context of a closed economy. This thesis sheds light on the performance of the augmented Taylor rules in a small open economy. For this purpose, a New Keynesian DSGE model with two types of financial frictions is constructed. The model is calibrated for the Czech Republic. The thesis provides four conclusions. First, incorporation of the financial variables (asset prices and the volume of credit) in the monetary policy rule is beneficial for macroeconomic stabilization in terms of lower implied volatilities of inflation and output. Second, the usefulness of the augmented monetary policy rule is the most apparent in case of the shock originating abroad. Third, there is a strong link between the financial and the real side of an economy. Fourth, if the banking sector experiences a sharp drop in bank capital that brings this sector into decline that further translates into the whole economy, monetary policy is not able to achieve macroeconomic stability using its conventional tools.