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The central-bank balance sheet as an instrument of monetary policy

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ABSTRACT

We extend a standard New Keynesian model to allow an analysis of "unconventional" dimensions of policy alongside traditional interest-rate policy. We find that quantitative easing in the strict sense is likely to be ineffective, but that targeted asset purchases by a central bank can instead be effective when financial markets are sufficiently disrupted, and we discuss the conditions under which such interventions increase welfare. We also discuss optimal policy with regard to the payment of interest on reserves.

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1. Introduction

The recent global financial crisis has confronted central banks with a number of questions beyond the scope of standard accounts of the theory of monetary policy. Monetary policy is ordinarily considered solely in terms of the choice of an operating target for a short-term nominal interest rate, such as the federal funds rate in the case of the Federal Reserve. Yet during the recent crisis, other dimensions of policy have occupied much of the attention of central bankers. One is the question of the appropriate size of the central bank's balance sheet. In fact, the Fed's balance sheet has grown dramatically in size since the fall of 2008 (Figs. 1 and 2).

As shown in Fig. 1, the component of the Fed's liabilities constituted by reserves held by depository institutions has changed in an especially remarkable way: by the fall of 2008 reserves were more than 100 times larger than they had been only a few months earlier. This explosive growth has led some commentators to suggest that the main instrument of US monetary policy has changed, from an interest-rate policy to one often described as "quantitative easing." Does it make sense to regard the supply of bank reserves (or perhaps the monetary base) as an alternative or superior operating target for monetary policy? Does this (as some would argue) become the only important monetary policy decision once the overnight rate (the federal funds rate) has reached the zero lower bound, as it effectively has in the US since December 2008? And now that the Federal Reserve has legal authorization to pay interest on reserves (under the Emergency Economic Stabilization Act of 2008), how should this additional potential dimension of policy be used?

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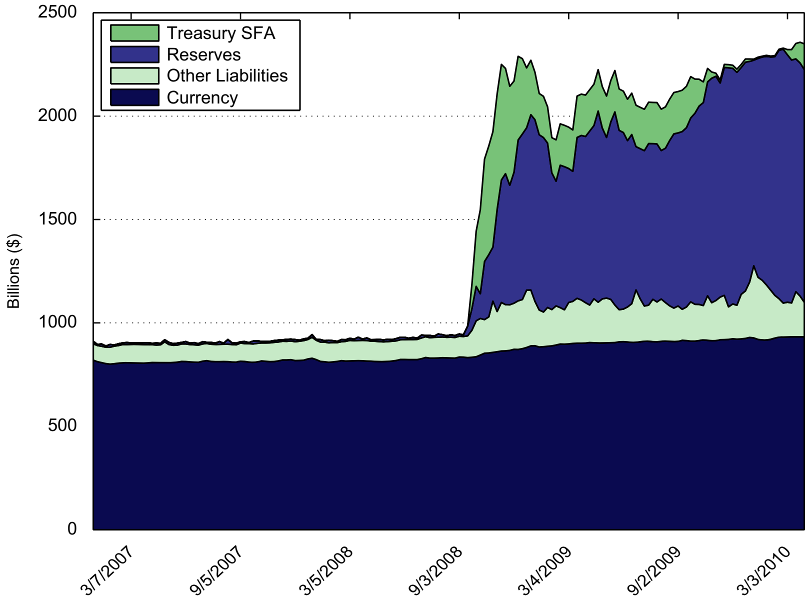

Fig. 1. Liabilities of the Federal Reserve. (Source: Federal Reserve Board.)

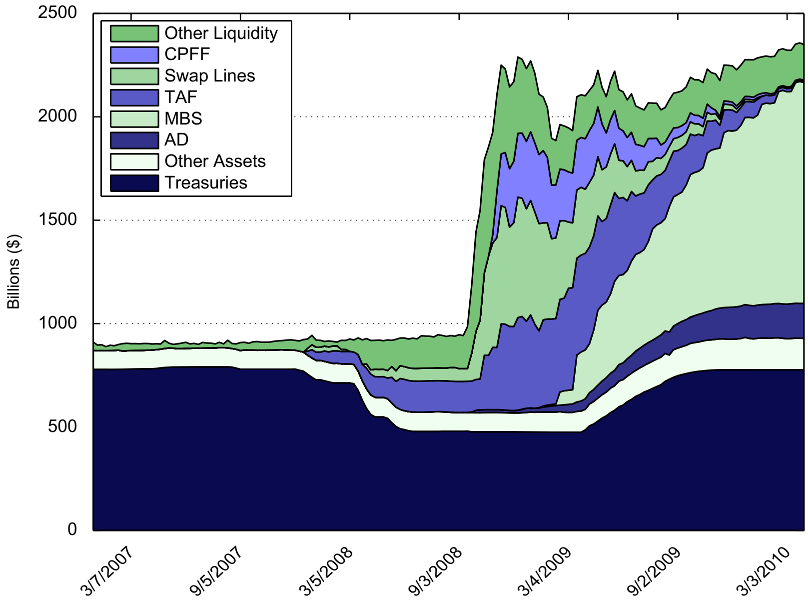

Fig. 2. Assets of the Federal Reserve. (Source: Federal Reserve Board.)

The past two years have also seen dramatic developments with regard to the composition of the asset side of the Fed's balance sheet (Fig. 2). Whereas the Fed had largely held Treasury securities on its balance sheet prior to the fall of 2007, other kinds of assets — a variety of new ''liquidity facilities'' , new programs under which the Fed essentially became a direct lender to certain sectors of the economy, and finally targeted purchases of certain kinds of assets, including more than a trillion dollars' worth of mortgage-backed securities — have rapidly grown in importance, and decisions about the management of these programs have occupied much of the attention of policymakers during the recent period. How should one think about the aims of these programs, and the relation of this new component of Fed policy to traditional interest-rate policy? Is Federal Reserve credit policy a substitute for interest-rate policy, or should it be directed to different goals than those toward which interest-rate policy is directed?

These are clearly questions that a theory of monetary policy adequate to our present circumstances must address. Yet not only have they been the focus of relatively little attention until recently, but the very models commonly used to

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