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The interest rate effects of government bond purchases away from the lower bound

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Abstract

I analyze the recent experience of unconventional monetary policy in Sweden to study the interest rate transmission mechanisms of government bond purchases when interest rates are away from the lower bound. Using dynamic term structure models and event study regressions I find that government bond purchases have important portfolio balance and signaling effects. The signaling channel operates mainly by lowering short-rate expectations in the intermediate segment of the yield curve, while the portfolio balance channel is effective in lowering longer maturity term premia. In addition, I find that target interest rate policy and government bond purchases operate in different segments of the yield curve. This suggests that a combination of the two policies can be used to lower interest rates across the whole maturity spectrum, making monetary policy more expansionary.

JEL Classification:
E43, E44, E52

Keywords:
quantitative easing, signaling channel, portfolio balance channel, dynamic affine term structure model, short-rate expectations, term premium

1. Introduction

During the financial crisis of 2008 and the following years, a number of central banks reduced their target interest rates - the traditional tool of monetary policy - essentially to their lower bounds. In the face of deteriorating economic conditions and deflationary pressures, and with little scope for further cuts in target interest rates, central banks initiated unprecedented expansions of their balance sheets by purchasing large amounts of government debt and other types of assets across different maturities. While it is widely accepted that such policies have helped to reduce long-term interest rates (Gagnon et al., 2011; Christensen and Rudebusch, 2012), the understanding of their interest rate transmission channels is at best partial and has become the topic of a growing literature.

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