

The Theory of Unconventional Monetary Policy

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This paper is about the effectiveness of qualitative easing (QualE), a form of unconventional monetary policy in which the central bank changes the composition of assets and liabilities on its balance sheet with the goal of stabilizing economic activity. Because qualitative easing is conducted by the central bank, it is often classified as a monetary policy. But because it adds risk to the public balance sheet that is ultimately borne by the taxpayer, QualE is better thought of as a fiscal or quasi-fiscal policy. This distinction is important because, in order to be effective, QualE necessarily redistributes resources from one group of agents to another.

We make the case for the effectiveness of qualitative easing by constructing a general equilibrium model where agents have rational expectations and there is a rich set of financial securities, but where some agents are unable to participate in financial markets. We show that a change in the composition of the central bank's balance sheet will affect asset prices. We also prove that, in our model, a policy in which the central bank stabilizes asset price fluctuations driven by changes in beliefs or sentiment improves the welfare of some agents without making anyone worse off. Importantly, this welfare-improving intervention does not involve any initial costs for the tax payer - i.e. the policy can be implemented by swapping debt for equity.