A Fiscal Theory of Central Bank's Solvency: Perils of the Quantitative and Qualitative Monetary Easing

Hidekazu Niwa*

Osaka University

Abstract

Under the Quantitative and Qualitative Monetary Easing (QQE), the Bank of Japan has purchased long-term Japanese government bonds. To study monetary policy after the Bank of Japan exits from the QQE, we develop a model in which the fiscal authority commits: (i) not to making fiscal adjustments needed to stabilize public debt, and (ii) not to providing financial supports for the central bank that incurs losses on its balance sheet due to a decline in the price of long-term bonds. Within this framework, this study investigates how the interaction of these commitments reduces the ability of monetary policy to control inflation after liftoff from the zero lower bound. We consider a situation in which the central bank that holds long-term bonds raises the nominal interest rates, and show three key results: (i) when the Taylor principle is not satisfied, under certain conditions, inflation right after liftoff cannot overshoot the central bank's target; (ii) when the central bank follows the Taylor principle, under certain conditions, it cannot prevent the economy from converging to the deflationary steady state; (iii) the central bank cannot achieve its inflation target by following the Taylor principle even if it is willing to allow the fiscal authority to default on its bonds.

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