

Central Bank Policy, Quantitative Easing, and Asset Price Transmission

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ABSTRACT

Central bank monetary policy—traditionally conducted through short-term interest rate targeting—reached its zero lower bound (ZLB) constraint during the 2008–2009 Global Financial Crisis and again during the COVID-19 pandemic, forcing the Federal Reserve, European Central Bank, Bank of Japan, and Bank of England to implement unconventional monetary policy including quantitative easing (QE): large-scale asset purchase programs that expand the central bank’s balance sheet and directly affect longer-term interest rates and risk asset prices. The Federal Reserve’s balance sheet grew from approximately \$900 billion before the GFC to \$8.9 trillion by 2022 through successive QE programs (QE1: 2008–2010, QE2: 2010–2011, QE3: 2012–2014, COVID-era QE: 2020–2022). This paper reviews QE’s theoretical transmission mechanisms, the empirical evidence on QE’s effects on interest rates and equity prices, the portfolio balance channel, the wealth distribution implications of unconventional monetary policy, and the financial stability implications of extended easy monetary conditions.

Keywords: Quantitative Easing; Central Bank; Zero Lower Bound; Portfolio Balance; Transmission Mechanism; Federal Reserve; Asset Prices; Unconventional Monetary Policy.

1. INTRODUCTION

Conventional monetary policy transmits economic stimulus primarily through the interest rate channel: reducing the short-term federal funds rate reduces borrowing costs for businesses and households, stimulating investment and consumption. This mechanism fails when the short-term rate reaches zero: the Fed cannot reduce nominal rates below zero without triggering cash holding that makes further easing ineffective. The Federal Reserve reached the zero lower bound in December 2008 and maintained near-zero rates through 2015, forcing reliance on unconventional policy tools to provide additional accommodation.

Quantitative easing—purchasing large quantities of longer-term government bonds and mortgage-backed securities from private market participants—affects asset prices through multiple channels. The portfolio balance channel (Tobin, 1969) is the primary mechanism: by removing duration and credit risk from the private sector’s portfolio and replacing it with risk-free central bank reserves, QE forces private investors to rebalance toward riskier assets, bidding up their prices and reducing their yields. This portfolio rebalancing spreads QE effects from the directly purchased assets to the broader universe of risk assets—equities, corporate bonds, real estate—through cascading substitution effects.

2. TRANSMISSION MECHANISMS OF QE

2.1 Portfolio Balance Channel

Gagnon, Raskin, Remache, and Sack (2011) in the *International Journal of Central Banking* provide the most cited empirical analysis of QE1’s effects, finding that the \$1.725 trillion first QE program reduced 10-year Treasury yields by approximately 91 basis points and 10-year agency mortgage-backed security yields by approximately 113 basis points—substantial effects consistent with significant duration removal from private portfolios. The signaling channel—QE’s communication that the Fed intends to maintain low rates for an extended period—reinforces the portfolio balance effect by reducing expectations of future short-term rates.

2.2 Equity Market Transmission

The equity market impact of QE operates through both the discount rate channel (lower long-term rates reduce the discount rate applied to future cash flows, increasing present values of equities) and the risk premium channel (portfolio rebalancing toward equities bids up their prices). Bernanke and Kuttner (2005) in the *Journal of Finance* established the interest rate-

equity return relationship pre-QE: a 1% unexpected rate cut increases equity prices by approximately 4–5%. During QE programs, equity prices responded positively to QE announcements—suggesting that markets interpreted QE as providing additional economic stimulus beyond the interest rate effect alone.

3. QE AND FINANCIAL STABILITY

Table 1. QE's stabilizing and potentially destabilizing financial effects.

QE Effect	Stabilizing	Destabilizing Concern
Corporate bond spreads	Credit easing reduces borrowing costs; supports investment	Compressed spreads may not reflect underlying credit risk
Housing prices	Lower mortgage rates support housing market recovery	Asset price inflation benefits owners over renters; wealth inequality
Equity prices	Higher equity prices improve household balance sheets; stimulate consumption	Disconnect between equity valuations and economic fundamentals
Risk-taking behavior	Higher asset prices reduce financial distress risk for leveraged entities	'Search for yield' drives excessive risk-taking in low-rate environment

4. QE TAPERING AND NORMALIZATION

The 2013 'taper tantrum'—when Federal Reserve Chairman Bernanke signaled that QE purchases might be reduced (not ended, but merely reduced in pace)—produced a sharp rise in 10-year Treasury yields from approximately 1.6% to 3.0% in about four months and significant capital outflows from emerging markets. This episode demonstrated that QE's communication effects—the 'lower for longer' interest rate signal embedded in QE—could be as important as the portfolio balance effect, and that normalization would require careful management of market expectations. The 2022 Fed tightening cycle—raising rates from 0.25% to 5.25% in 15 months while simultaneously reducing the balance sheet—represents the most aggressive monetary tightening since the 1980s, testing the durability of QE's financial stability effects when reversed.

5. CONCLUSION

Quantitative easing has proved effective in providing monetary accommodation when conventional interest rate policy reaches the zero lower bound, with empirical evidence supporting meaningful effects on long-term interest rates, credit spreads, and equity prices through portfolio balance and signaling channels. The distributional consequences of QE—which benefits asset holders disproportionately—have raised legitimate questions about whether unconventional monetary policy exacerbates wealth inequality. The 'search for yield' behavior induced by sustained low rates raises financial stability concerns about excessive risk-taking and mispricing of credit risk that may create vulnerabilities in subsequent tightening cycles. Future research should examine whether the 2022–2023 aggressive tightening cycle produced the systemic risk crystallization that financial stability concerns predicted, and how central banks should integrate financial stability objectives into future monetary policy frameworks.

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