

I introduce maturity and currency mismatches in the central bank balance sheet. When such a central bank's remittances to the Treasury is constrained, balance sheet arithmetic shows that it loses freedom in its policy actions. The expected future change of the short-term nominal interest rate or the nominal exchange rate get determined by balance sheet considerations: if they increase today, they have to decrease in future. I embed the balance sheet constrained central bank in a standard dynamic general equilibrium model and study monetary policy transmission mechanisms. Following a positive short-term nominal interest rate shock, central bank balance sheet considerations lead, dynamically, to a drop in the short-term interest rate and a positive correlation between it and inflation and a negative correlation between it and the real interest rate. This holds even though the model has sticky prices. Central bank balance sheet considerations make forward guidance less effective. Following news of a negative short-term nominal interest rate shock, while inflation and output increase initially, they do so by a diminished amount, and are in fact followed by deflation and contraction in economic activity in future. This is because the real interest rate remains persistently high even though the nominal interest rate is low.