Sterilized FX Interventions: Benefits and Risks[*]

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December 15, 2022

Abstract

In recent decades central bankers in many countries use sterilized intervention to smooth exchange rate fluctuations while interest rate policy is used to meet domestic policy objectives about inflation and output. This approach to policy contemplates that central bankers in effect have two tools. We explain why it is that in standard open economy models, monetary policy makers in fact have only one tool. We discuss what extra model ingredients are required to justify the second tool, which creates the possibility of pursing domestic and foreign objectives simultaneously. We use a small open economy model to illustrate our observations and to discuss the benefits and potential pitfalls of using the two tools, when circumstances justify the availability of both tools. In the model, there are financial shocks that shift the exchange rate and disrupt local demand by inflicting capital losses and gains on the balance sheets of investing firms. We investigate the welfare consequences of using sterilized foreign asset purchases and sales to mitigate these disruptions, by minimizing potentially disruptive interest rate changes. We also examine the risk that the central bank under-estimates the persistence of a financial market shock and that sterilized intervention leads it to run dangerously low on foreign reserves.

[*]Dalgic gratefully acknowledges funding by the Deutsche Forschungsgemeinschaft (DFG, German Research Foundation) through CRC TR 224 (Project C02).

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