Essays on Economic Policy (ESPE in Spanish) - External Debt and Monetary Policy Autonomy

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During a time of rising world interest rates, the central bank of a small open economy may be motivated to increase its own interest rate to keep from suffering a destabilizing outflow of capital and depreciation in the exchange rate. Empirically, this paper shows that this is especially true for a small open economy with a current account deficit, which relies on foreign capital inflows to finance this deficit. In addition, the method of current account financing has a large effect on whether or not the central bank will opt for exchange rate and capital flow stabilization during a time of rising world interest rates. A current account deficit financed mainly through reserve depletion or the accumulation of private sector debt will cause the central bank to pursue de facto exchange rate stabilization, whereas a current account deficit financed through equity or FDI will not. Quantitatively, reserve depletion of about 7% of GDP will motivate the central bank with a floating currency to adjust its interest rate in line with the foreign interest rate to where it appears that the central bank has an exchange rate peg.

Fuente: https://www.banrep.gov.co/en/publications-research/espe/external-debt-and-monetary-policy-autonomy