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Nalini Prasad^a

Abstract

I incorporate sterilized intervention policies with capital controls into a small open economy model. A central bank can influence an economy's holdings of foreign bonds through their sterilized interventions, allowing policymakers to affect the terms of trade. I find that policymakers choose foreign bond holdings to take advantage of the market power that a nation has over its terms of trade. Under a floating exchange rate regime, these policies can simultaneously reduce real exchange rate and inflation volatility. I suggest a rationale for sterilized interventions with capital controls; a central bank can improve the international purchasing power of domestic consumers.

Keywords: Small open economy, sterilization, capital controls

JEL codes: F32, F41

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