Imperfect financial integration, uncovered interest parity and central bank foreign exchange reserves

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Abstract

This paper explores the implications of costly international portfolio adjustment by private agents, on the effects of central bank interventions on interest rates, and on short and long-horizon uncovered interest parity (UIP). Using an incomplete-markets two-country monetary model with bonds in positive net supply, we show that with portfolio adjustment costs, surprise central bank interventions can have a substantial negative effect on foreign interest rates. In addition, central bank interventions and monetary policy shocks cause deviations from UIP, or a “forward premium anomaly”. As the time horizon increases, the model-implied regression coefficients become more consistent with the long-run evidence in favor of UIP, as in the data for the major currencies. A crucial element of the analysis is the interaction between the central bank balance sheet, the agents budget constraints, and market clearing conditions in both bond markets.

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