Monetary Policy and Foreign Exchange Intervention in a Small Open Inflation-Targeting Country

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Abstract
This paper investigates the effect of conventional monetary policy and the efficacy of foreign exchange intervention under inflation targeting, using a small open semi-structural model specific to the Thai economy with Bayesian estimation. We find that the conventional behavior of the central bank is consistent with the standard empirical evidence on monetary transmission mechanisms. We also find that the uncovered interest rate parity condition does not hold. Further, foreign exchange intervention, which affects the exchange rate through the portfolio balance channel, is an important determinant of exchange rate dynamics. It is also a supplement to mitigate the pressures of headline inflation, which has been increasingly sensitive to external shocks. On the other hand, intervention is occasionally found to reduce the effect of conventional monetary policy.

Key words: foreign exchange intervention; small open semi-structural model; Bayesian estimation; inflation targeting

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