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Working Papers on Economics - Banking Limits on Foreign Holdings: Disentangling the Portfolio Balance Channel

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In this paper we analyze the effects of financial constraints on the exchange rate through the portfolio balance channel. Our contribution is twofold: First, we construct a tractable two-period general equilibrium model in which financial constraints inhibit capital flows. Hence, departures from the uncovered interest rate parity condition are used to explain the effects of sterilized foreign exchange intervention. Second, using high frequency data during 2004-2015, we use a sharp policy discontinuity within Colombian regulatory banking limits to empirically test for the portfolio balance channel. Consistent with our model's postulations, our findings suggest that the effects on the exchange rate are short-lived, and significant only when banking constraints are binding.

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