

Sterilization of foreign exchange inflows in Tanzania: extent and effectiveness

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Tanzania has received substantial foreign exchange inflows as a key instrument for growth, Development and poverty reduction initiatives over the past three decades. The inflows resulted in a build-up of foreign exchange reserves. The increase in volume of inflows if not accompanied with proper monetary authority intervention results into economic overheat. This has perhaps compelled the central bank to undertake policy interventions to overcome the likely side effects of excessive inflows. Most studies carried inside and outside Tanzania provide an explanatory reading of effects of foreign exchange inflows, how interventions affect the exchange rate and some few focused on empirical analysis of magnitude and effectiveness of interventions as well as the cost to the central bank. It is on this account that the broad objective of this study is to fill this gap.

After undertaking all the necessary diagnostic statistical test of the data used for regression, Three-Stage Least Squares (3SLS) method was used to estimate the sterilization and offset coefficients. For robustness the 2SLS and GMM estimators have been used and OLS too for comparison purposes in which, the three estimators (3SLS, 2SLS and GMM) were statistically significant and differ only marginally, but they differ fairly substantially with OLS estimates. Results indicate that the central bank fully sterilized the effects of foreign exchange inflows and the operations went with costs to the central bank.

Findings indicate that the value of the estimated offset coefficient is notably lower relative to the estimated sterilization coefficient. This indicates a relatively high degree of monetary policy independence in neutralizing foreign inflows. The findings have an important implication that, the monetary authority in Tanzania has to keep the practice of independence in formulating an independent monetary policy.