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MEET THE TRILEMMA

Large-scale capital inflows are forcing policymakers in emerging markets to choose between exchange rate appreciation, domestic adjustment, and capital controls. Increasingly, they are choosing the third option.

Korea has just announced that it's reimposing a tax on foreign investments in government bonds. Seoul is joining a growing club of G20 emerging economies turning to capital controls. China and India have long imposed controls on capital account transactions; Argentina moved back to controls in the aftermath of 2002's default; Brazil reintroduced a tax on inflows last year, and hiked the tax rate twice last month; Indonesia introduced minimum holding periods for investments in SBIs; and South Africa is reportedly considering some form of entry tax. Capital controls are back in fashion. Why?

Surging capital inflows (see IEC#6) are confronting policymakers in emerging markets with a familiar problem: Do they let their (nominal) exchange rates appreciate? Do they intervene and risk domestic inflation and asset bubbles? Or should they turn to capital controls? They are grappling with what is known as the trilemma (or the impossible trinity). According to the trilemma, policymakers can opt for only two out of the following three policy choices:[1]

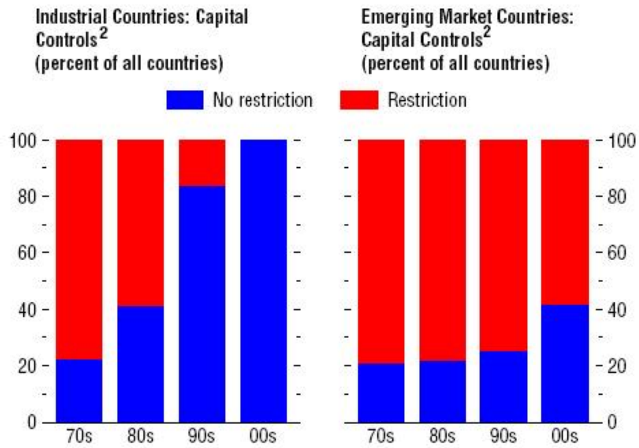
1. A stable exchange rate;

2. An independent national monetary policy (where local interest rates can diverge significantly from the 'world' rate); and

3. Free international capital mobility.

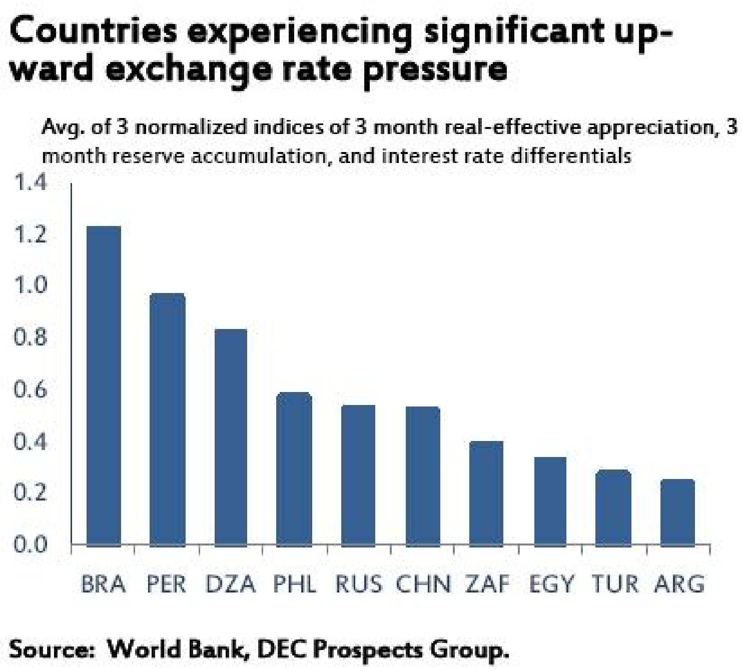
Typically, countries opt for different combinations depending both on their preferences and on their relative level of financial development. Australia, for example, has opted for #2 and #3, allowing the value of the A$ to be set in global foreign exchange markets. In contrast, our main trading partner, China, has picked #1 and #2 and continues to impose significant capital controls.

The same constraints imposed are also visible in the shifting configuration of the international monetary system over the long term.[2] During the nineteenth century, for example, the operation of the gold standard combined fixed exchange rates, capital mobility, and quite limited monetary independence. The post-World War Two Bretton Woods system (or Bretton Woods I as we now have to call it) comprised national monetary policies, fixed-but-adjustable exchange rates, and strict capital controls. In the modern era, the trend has been towards free capital mobility again, although several major emerging markets, including China and India, have remained important holdouts and continue to retain substantial controls over their capital accounts:



Source: Figure 3.2 in International Monetary Fund (IMF), *World Economic Outlook: Globalization and external imbalances*. (2005)

The trilemma is biting again thanks to a combination of strong capital inflows, low global interest rates (plus quantitative easing) and fast-growing emerging economies, which together have produced significant upward pressure on exchange rates across a range of emerging markets:



Source: World Bank Development Prospects Group, *Weekly global economic brief: 11 November*. (2010)

The problem for emerging markets policymakers is that pretty much all of the choices currently on offer come with drawbacks:

- Letting the nominal exchange rate appreciate raises fears of lost international competitiveness, particularly in economies keen on pursuing strategies of export-led growth. This is, of course, even more the case when other countries with similar export structures are intervening heavily to prevent *their* exchange rates appreciating. Moreover, under current circumstances there is also a very real risk of major currency overshooting and the IMF has already warned that real exchange rates in some emerging markets (particularly in Latin America) are starting to look overvalued;[3]

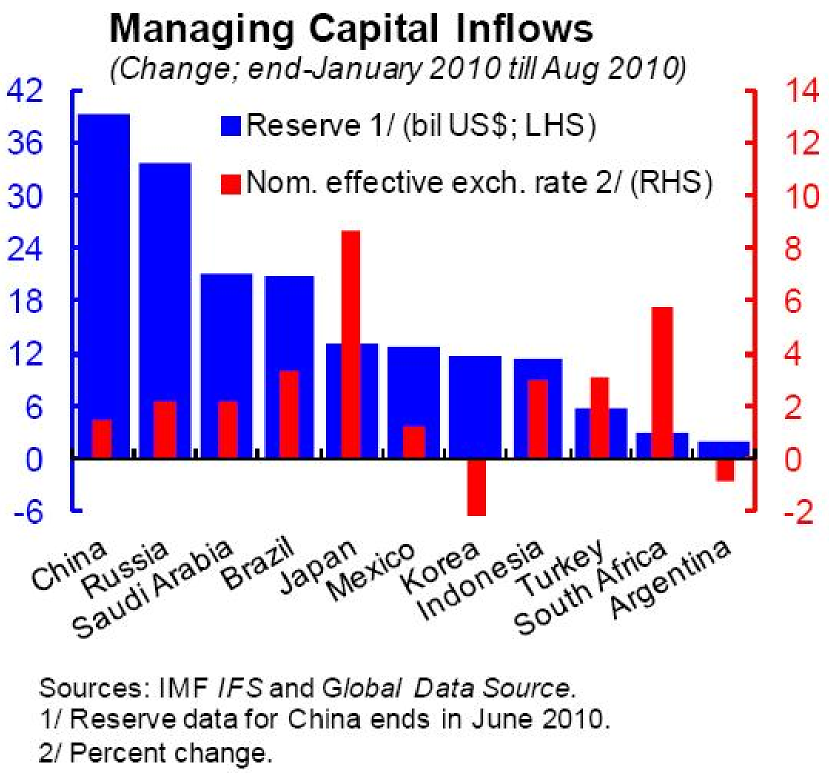
- Non-sterilised foreign exchange intervention can stem the upward pressure on the exchange rate, but only at the cost of swelling domestic liquidity, and so risking inflationary pressures and asset bubbles. Sterilised intervention, on the other hand, is typically assumed to be less effective, and will tend to sustain the interest rate differentials that help encourage inflows in the first place;

- Fiscal tightening would help take some of the pressure off monetary policy, although there is some risk that the perceived increase in creditworthiness that results will encourage further inflows;

- Targeted capital controls on inflows can also help, although the evidence suggests that they become progressively leakier over time so if current developments reflect a long-term portfolio adjustment, they might offer only temporary relief.[4] Moreover, capital controls used to be viewed as 'bad policy' by bodies such as the IMF, and so their adoption tended to bring with it a certain stigma for the user – although this last feature is now changing.

In practice, countries have responded with a combination of most of these options, with the exact mix varying significantly across economies. So, for example, while some countries like Brazil and South Africa have allowed large upward movements in their currencies, others like China have relied much more heavily on intervention.

Perhaps the most striking development to date, however, is the big change in the orthodoxy on capital controls, which have now been rehabilitated as a standard part of the policymakers' tool kit. In particular, the IMF, which in the past used to be a vocal critic, now endorses them as one of a set of appropriate policy responses to large capital inflows.[5] This change says some interesting things about the world economy at present. To a large extent, the new orthodoxy presumably reflects the current macro-economic conjuncture as well as lessons learned from the GFC and other recent economic developments. But it might also indicate recognition of the changing balance of economic and hence political power in the world. With new and important players such as China holding very different views on exchange rate policy and capital controls from the previous orthodoxy, it makes sense for the Fund and others to trim their sails a bit to the new prevailing winds.



Source: International Monetary Fund (IMF), *Global economic prospects and policy challenges*. (2010)

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[1] For a recent discussion see N. Gregory Mankiw, The trilemma of international finance. *The New York Times*, 10 July 2010.
[2] Maurice Obstfeld, Jay C. Shambaugh and Alan M. Taylor, The trilemma in history: Tradeoffs among exchange rates, monetary policies and capital mobility. *The Review of Economics and Statistics* 87 (3) 2005.
[3] International Monetary Fund (IMF), *Global economic prospects and policy challenges*. Washington DC, International Monetary Fund, October, 2010
[4] In addition, countries that have controls on capital outflows could loosen these and generate offsetting flows.
[5] Jonathan D Ostry, Atish R Ghosh, Karl Habermeier, Marcos Chamon, Mahvash S Qureshi and Dennis B S Reinhardt, *Capital inflows: The role of controls.* IMF Staff Position Note. Washington DC, International Monetary Fund, 19 February, 2010.