

The impossible trinity reveals economics essay



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Introduction

The Impossible Trinity reveals that a country cannot have: 1) Fixed Exchange Rate, 2) Free Capital Movement and 3) Independent Monetary Policy all at the same time. It can only choose two out of the three factors.

The fixed exchange rate regime enables a home currency to be pegged to a single currency; to a basket of currencies or to an economic unit of gold. A pegged currency usually adheres to the same interest rate of the reserve country.

The fixed exchange rate is implemented to stabilize home currency's value against the currency it is tied to; preventing extreme fluctuations. Also, a fixed exchange rate helps fosters a desired conducive environment that facilitates trade.

Free Capital Movement creates the freedom for investments to move in and out of the country; where trade barriers such as embargoes, quotas and tariffs are eliminated. This attracts foreign investments where developing countries can benefit from foreign expertise and know-how. It also enables countries to source of external funds should a crisis occurs.

Independent monetary policy refers to monetary authority's autonomy to regulate money supply in the market. As a result, the central bank can exert authority to adjust interest rates to reduce unemployment or to curtail inflation. Also, this entitles them to make decisions strictly based on economic goals without being influenced by political interests or pressures.

Three Possible Combinations

As suggested by Paul Krugman, a country can only choose 2 out of the three factors. The following are the three possible combinations within the trinity.

Fixed Exchange Rate and Free Capital Movement

Independent monetary policy is forgone in this situation. Since capital is allowed to flow freely; the buying and selling of the currency is completely controlled by the market's demand and supply. If Foreign Direct Investments (FDI) increases; hot money will enter into the home country with ease, increasing the demand for domestic currency. The increase in demand would cause the domestic currency to appreciate. However, the fixed exchange rate in this scenario does not allow the currency to increase in value. Rather than appreciating, the central bank has to sell more home currency in the foreign reserves market to maintain its pegged currency. This causes the amount of its domestic currency in reserves to decrease. Also, the central bank will not be able to adjust interest rate as that would again impact the fixed exchange rate economic goal. Thus, the independent monetary policy cannot be supported under the fixed exchange rate and free capital movement combination.

Free Capital Movement and Independent Monetary Policy

Fixed exchange is forgone in this scenario. With an independent monetary policy and free capital movement; any changes in interest rates by the central bank would drastically affect the circulation of capital. Take for example the central bank lowers the interest rate. Due to free capital movement, hot money will move out and into another country that offers the higher interest rate. The selling of home currency to buy the foreign

currency with the higher interest rate would result in a decrease in demand for the home currency in the exchange market. This causes the value of the home currency to depreciate against other currencies. Therefore, a fixed exchange rate cannot persist. The same concept applies when the central bank decides to raise interest rates.

Fixed Exchange Rate and Independent Monetary Policy

China at present adopts this combination. With a fixed exchange rate and independent monetary policy, a country's central bank has to control capital movement. Take for example a booming economy. With strong capital inflows, this would lead to a greater demand for the home currency.

However, this also increases the country's risk of inflation. To curb the inflation, the central bank would then raise domestic interest rates relative to the base country due to the fixed exchange rate criteria, which on the contrary, will result in even more capital flowing, causing a higher risk of inflation. Thus, the country has no option but to give up free capital movement to manage money supply in order to curb inflation.

In reality, this combination in the impossible trinity is ineffective in an open economy. The central bank although free to make monetary decisions free from the government's authority; has very little control over its exchange rate and interest rate, making this combination very unsustainable.

Countries thus cannot afford to implement this combination if they are not ready to give up free capital movement, by allow currency to appreciate or depreciate as dictated by base country; or to forgo independent monetary regime through allowing domestic interest rates to be determined by interest rate of the base country.

3. China's Economic Outlook

Today, China is the most populous country in the world with a total population of approximately 1.344 Billion. Also, it is the second largest economy in the world, registering an average GDP growth of 10% per annum. US is still China's largest trading partner; followed by ASEAN, Europe and Australia.

With relatively weak imports coupled with the nation's high saving rate in which Chinese residents only consume 36%^[1] of the country's GDP; China managed to secure USD\$31.7 Billion in trade surplus this year, while accumulating a staggering USD\$3.28 Trillion in foreign reserves through the years.

Thus far, China is largely export-driven, comprising of 39.7% of its annual GDP; where the country mainly exports electrical machinery, textiles and manufactured goods; registering USD\$186 Billion^[2] in export revenues, as of September, 2012.

China's Trinity

Based on the above analysis, China's trinity consists of independent monetary policy and fixed exchange rate, forgoing free capital movement. However, there are several key issues pertaining to this combination such as the effectiveness of China's capital controls; and how this will affect its ability of China to maintain a fixed exchange rate and retain monetary independence.

Looking at China's fixed exchange rate regime, its currency was pegged 8.27 RMB to 1 USD between 1994 and 2005. With overheating concerns and <https://assignbuster.com/the-impossible-trinity-reveals-economics-essay/>

extreme liquidity (from competitive pricing as a result of an under-valued RMB); China eventually gave into pressures from the International Monetary Fund (IMF) and trade barrier fears to remove the pegged exchange rate in 2005. From 2005 to 2008, the Chinese RMB started to appreciate gradually. However, in 2008, it converted back to the fixed exchange rate due to the financial crisis. Shortly after in 2010, China reformed its peg to the crawling peg, where it fixes its exchange rate but changes the fixed rate periodically. The relative stable exchange rate provides China with more certainty through lessen speculative activities and a conducive environment that facilitates trade.

In terms of independent monetary policy, China has a central bank, also well known as the People's Bank of China (PBOC); which is independent from the government and who holds authority to control interest rates to achieve macroeconomic stability for the country. Currently, the PBOC sets a higher interest rate that serves as a corrective mechanism to correct for the rising inflation rate.

As part of China's efforts to control capital flow, its government strictly regulates the inflow of hot money from FDI into the country; so as to control money supply and to prevent easy credit. For instance, foreigners cannot purchase a property without studying or working in its country for at least a year. Besides maintaining the inflow of hot money, outflow of currency is also stringently regulated. For instance, Chinese citizens going abroad can only carry a certain amount of domestic and foreign currency out of the country to maintain money supply equilibrium. However, is capital control the way forward for China?

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It can also be seen that although China pursued capital control, it still has some form of capital movement through the central bank regulating its inflow/outflow of capital. With China's huge trade surplus and currency appreciation, it certainly cannot afford to restrict its capital movements as that would cause high inflation rates and erode its economic competitiveness. Thus far, China is employing sterilization policies or the buying and selling of foreign reserve currencies, to directly controlling the supply and demand of the currency in the economy. For instance, the buying of foreign assets which initially go to other countries will then soon circulate back into the Chinese's economy as payments for exports. Temporarily "parking" its cash into another country helps to reduce money supply in its own economy to fight inflation.

However, its sterilization operations have in recent years proven to increasingly costly. China's state-owned banks have also relaxed its lending requirements due to huge credits in the market. This thus led to high risk lending and borrowing.

As a result of high borrowings, there have been an increase in non-performing loans (NPL) or loans which have exceeded 90 days or more in payments of interest rate. In 2003, NPL alone conceding 47% of China's GDP. This forced the central bank to set a limit to the reserve ratio on China's state-owned banks to prevent China's banking system to collapse.

China has since resolved this issue by gravitating towards freer capital flow. This allows foreign banks to enter into China's banking system, inducing competition to its state-own banks. These new bank entrants thus create a

competitive playing field which inevitably compels state-owned banks to operate and allocate resources more efficiently in order to remain competitive. As a result, NPL has decreased over the years, with state-owned banks gaining competitiveness and profitability.

Overall, the paper concluded that capital controls is least likely to be sustainable for China in the long term. If China continues to tighten capital controls, it will lose its national economic competitiveness due to missing developmental opportunities; which is crucial for China's economic progress. It is also important to note that the world economy today is increasingly interdependent and the way forward for China could inevitably be financial integration through freer capital flows; to ensure its country's long-term economic growth.

As the paper revealed, China is moving towards freer capital flows. Thus far, China's economic developments are challenging the prevailing nature of the impossible trinity. Looking at future developments, more studies need to be conducted to identify better ways to mitigate the Trilemma in the long run.