

Special Feature C

Revisiting Monetary Policy Autonomy In Asia And Beyond: Trilemma, Dilemma Or 2.5 Lemma? by Ramkishen S. Rajan¹

Introduction

Following the Asian Financial Crisis of 1997–98 and consequent collapse of the soft US dollar pegs, emerging market and developing economies (EMDEs) in Asia grappled with the question of the appropriate choice of exchange rate regime. Drawing on Mundell's (1963) monetary trilemma, the dominant paradigm was that in an era of financial globalisation, the exchange rate choice boiled down to opting for either flexibility, on the one hand, or credible pegging, on the other. Any arrangement that lies in between these extremes was considered to be inherently unstable.

Consequently, *ceteris paribus*, the choice of exchange rate regime seemed to hinge on what was a more potent policy instrument to affect aggregate demand—domestic interest rates or exchange rates? If domestic demand is a larger share of aggregate demand, then controlling the internal price of money is crucial. In such a case, the country needs a relatively greater degree of interest rate policy autonomy and hence may prefer a more flexible exchange rate regime. However, if external demand constitutes a larger share of aggregate demand, then it is the external price of money that is paramount. In this instance the country might prefer to closely manage the exchange rate and consequently forsake its interest rate policy autonomy.²

Taking a quick scan across Asia (Rajan, 2012), it is not surprising to see that many smaller economies have fixed or heavily managed exchange rate regimes—Hong Kong and East Timor to the US dollar (the former via its Linked Exchange Rate System and the latter via complete dollarisation), Singapore to a basket of currencies (trade-weighted exchange rate), Brunei to the Singapore dollar, and Nepal and Bhutan to the Indian rupee. Larger Asian economies such as Japan and South Korea have chosen a relatively more flexible exchange rate regime, as has India, which has adopted an inflation-targeting regime since 2016. There are some exceptions, of course. China, despite having a large domestic economy, has relied on a heavily managed exchange rate regime for decades. However, as China moves in earnest to rebalance its economy and develop its financial markets, it has been gradually attempting to transition to a relatively more flexible market-determined exchange rate regime.

Some other economies in the ASEAN bloc such as Malaysia and Vietnam have chosen to continue to manage in the middle, i.e., they have forsaken some degree of both monetary policy autonomy and exchange rate stability while proactively using capital flow management measures to deal with volatile capital flows. Other ASEAN economies

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² Needless to say that there may be political economy and other factors that determine the actual choice of exchange rate regimes.

such as Indonesia, the Philippines and Thailand which have in the past also ‘managed in the middle’, have instead moved more clearly in the direction of greater exchange rate flexibility in

recent times, while strengthening the use of interest rates as an independent policy instrument, as part of their inflation-targeting regimes.

International Reserves And Exchange Rate Intervention

Despite the transition towards greater exchange rate flexibility, there exists a degree of unease about this as a policy choice, and thereby whether to let the exchange rate act as the primary shock absorber in many Asian economies. To be sure, while the empirical evidence suggests that exchange rate flexibility has increased over time and there is definitely less of an inclination towards rigid US dollar pegs, central banks continue to actively intervene in foreign exchange markets (Cavoli *et al.*, 2019a).

With regard to foreign exchange interventions, there is a line of work that suggests that EMDEs in Asia have undertaken asymmetric interventions in response to shocks. In particular, interventions are more likely or more frequent when the goal is to prevent sharp appreciations than depreciations—which characterises the so-called ‘fear of appreciation’ (Levy-Yeyati *et al.*, 2013; Pontines and Rajan, 2011).

It appears that there has been ‘leaning-against-the-wind’ when the exchange rate strays too far from levels thought to be consistent with medium-run fundamentals, especially when countries are faced with balance of payments surpluses. This in turn explains in part the sustained reserve accumulation apart from those during crisis periods. However, there does not appear to be a prolonged and systematic intervention strategy *per se*.

Foreign exchange intervention is often accompanied by sterilisation with the goal of insulating interest rates from the effects of such intervention. While sterilised intervention may not be effective in advanced economies (AEs), in EMDEs it remains a viable—but not costless—policy tool (Blanchard *et al.*, 2015), thanks to imperfect asset substitutability and imperfect capital mobility.

Dilemma, Trilemma Or 2.5 Lemma?

Following the Global Financial Crisis and the advent of quantitative easing, the world has been awash with global liquidity which has impacted all EMDEs. Since then, the debate has shifted to whether exchange rates regimes—fixed, flexible or intermediate—actually matter at all in the face of the global financial cycle. Rey (2015) triggered the debate by arguing that the trilemma may not even be a valid characterisation of the constraints imposed on EMDEs in the international financial system (also see Bruno and Shin, 2015; Passari and Rey, 2015). She highlighted the role of the VIX (the Chicago Board Options Exchange volatility index) and the US Federal funds rate in impacting global capital flows, bank leverage and asset prices, which have a strong common component (i.e., they are highly correlated across economies) regardless of the exchange rate regime. According to this line of reasoning, in the face of a global

financial cycle, economies are confronted with a monetary dilemma rather than a trilemma, i.e., they would have to choose between autonomous monetary policy or free cross-border capital flows.

However, since then a growing body of work has argued that the global financial cycle may be exaggerated (for example, Cerutti *et al.*, 2017a) and the demise of the trilemma is highly premature. Exchange rate flexibility remains associated with greater monetary policy autonomy (Klein and Shambaugh, 2015 and Obstfeld *et al.*, 2019). In an important finding, Han and Wei (2018) document the existence of an asymmetric pattern or 2.5 lemma between the trilemma and dilemma whereby a flexible exchange rate affords a country a degree of monetary policy autonomy when the centre

country (the US, Europe, and UK) raises rates but not when it lowers them.

Cheng and Rajan (2019) confirm this asymmetric pattern or 2.5 lemma, but instead find that there seems to be evidence of ‘fear of capital reversal’ rather than a ‘fear of appreciation’. To be sure, when base economies³ raise their interest rates, peripheral economies may respond by raising interest rates to prevent capital outflows or the loss of reserves, since capital controls have generally proven to be rather ineffective. The authors further find that this nexus holds true specifically in the case of economies with low reserve levels. In other words, there may be a ‘fear of capital reversal’ or possibly a ‘fear of reserve loss’ (Aizenman and Sun, 2012) as noted previously.⁴ On the other hand, when interest rates in the base country decline, peripheral economies may experience massive surges in capital inflows if they stand pat on interest rates. Nevertheless, they can maintain monetary policy autonomy via a combination of sterilised foreign exchange intervention (leading to reserve accumulation) as well as tightening of capital controls, and/or use of macroprudential policies (MaPs).

The body of empirical literature on MaPs, although of relatively recent vintage, is fast growing. The primary focus of the literature to date has been on the effectiveness of MaPs in limiting pro-cyclicality of credit growth and/or house price inflation across a cross-section of economies (see the literature review in Cavoli *et al.*, 2019b). In one of the most comprehensive studies on the subject, Cerutti *et al.* (2017b) document the use of MaPs across 119 economies

from 2000–13 across various instruments. The data came from the 2013 IMF Survey on Global Macroprudential Policy Instruments (GMPI) spanning 18 different instruments (of which the study uses 12). They find that MaPs are less effective at mitigating credit booms in more open economies and those with deeper and more developed financial systems. The authors also find that MaPs work better during boom periods.

Aizenman *et al.* (2017) use the same GMPI database and divide the sample into centre economies (the US, Japan and Eurozone) and peripheral economies to understand the effect of monetary policies of the former on the latter. The authors also estimate spillover effects and global synchronisation of financial or macroeconomic variables. Their empirical results suggest that the impact of MaPs is asymmetric and MaPs tend to be most useful when lax monetary policy of a centre economy results in capital inflows into a peripheral economy.

This asymmetric finding is consistent with the argument laid out by Cheng and Rajan (2019) in that monetary autonomy is more likely to be gained or invoked with exchange rate flexibility when the centre country loosens monetary policy than when the centre country tightens policy, as in the former situation economies have other tools (such as MaPs and sterilised intervention) to manage surges in capital inflows. Along similar lines, Obstfeld *et al.* (2019) have highlighted that exchange rate flexibility along with capital controls and MaPs are important components of a broader toolkit for managing domestic financial and macroeconomic conditions.

Conclusion

Long before MaPs became prominent in the AEs (since 2009), EMDEs in Asia and elsewhere have been actively using them (credit, liquidity and capital-based), especially those that are property-related. After all, housing is the largest

component of household wealth and real estate market stability is usually closely linked to overall financial stability. According to the IMF (2018), as of April 2018, 141 economies reported a total of just over 1,300 MaPs or an average of 9.3 per

³ The choice of base country is determined by the peripheral countries’ previous pegging histories or the dominant currency in the region. There are eight base countries in the sample: the US, Germany, France, South Africa, the UK, India, Portugal and Malaysia.

⁴ Aizenman and Hutchison (2010) emphasise the importance of reserves in helping EMDEs overcome the trilemma.

country, more or less evenly divided between AEs and EMDEs. There is growing recognition that beyond their impact on financial resilience, MaPs play a role in helping economies regain some degree of monetary policy autonomy during periods of capital inflow booms by attenuating the effects of global financial cycles.

With their widespread use, there are concerns as to whether MaPs actually lead to risk mitigation or merely transfer risk internally (which could have implications for financial stability), as well as the extent to which they may cause capital flow deflection across economies, hence impacting the credit cycle in another jurisdiction. While MaPs are national in nature, given their potential spillovers on other economies, their conduct calls for a greater degree of coordinated regional monetary consultation, if not outright policy coordination. Some observers have expressed concerns that the uncoordinated use of MaPs might lead to a ‘regulatory war’ between

countries if left unchecked (da Silva and Chui, 2017). However, the empirical evidence to date remains unclear.

Given the difficulty of devising a MaP framework or code of conduct at a regional—let alone a global—level, Asian economies have thus far chosen to maintain autonomy over national financial policies in order not to compromise domestic financial stability. Following the ‘Financial Trilemma’, à la Schoemaker (2011), this choice for financial stability and financial autonomy has come at the expense of financial integration. This contrasts with the European push towards a banking union, i.e., the Eurozone is moving towards financial stability via greater financial integration at the cost of national sovereignty over financial policies. Asian economies might benefit from regional rules of good conduct regarding the use of MaPs while still ensuring sufficient flexibility given differing country contexts.

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