The Impossible Trinity and CAC

Last month, in a speech at the Gokhale Institute of Politics and Economics in Pune, Dr. Raghuram Rajan referred to his hope that "*we will get to full capital account convertibility* (CAC) *in a short number of years.*" Since then, a number of commentators in the Indian media have questioned the timing of full CAC, few questioning the basic wisdom.I should mention that I was a member of both the 1997 and 2006 committees on CAC, and have continued to study the pros and cons of CAC (and financial liberalization in general), more so after the 2008 financial crisis.

Nobel Laureate Robert Mundell first propounded (in 1962) the concept of the Impossible Trinity: that a fixed (or managed) exchange rate, an independent monetary policy and an open capital account cannot co-exist; that policy makers need necessarily to forego one of the three. In practice, even before the theory was propounded, policy-makers have done so.

Looking at the issue in a historical context, in the era of the gold standard most countries practiced a liberal capital account and a fixed exchange rate with gold, foregoing an independent monetary policy. Money supply was determined by the gold held by the central bank and interest rates were determined by the need to attract or repel gold flows. The exchange rate was suspended in wars or other national emergencies, but restored after it was over. One example: Britain restored, in 1925, convertibility of sterling into gold at the pre-war parity despite the inflation in war years. Despite high interest rates, the parity could not be sustained and was abandoned in 1931, in effect devaluing the pound: **meantime, the real economy had experienced a deep recession and unemployment**. US devaluation followed in 1934. It had earlier raised import tariffs. Competitive devaluations and trade protectionism deepened the global output fall resulting into the great depression of the 1930s.

The experience of the 1930s clearly influenced the fixed exchange rate framework introduced as part of the Bretton Woods system put in place at the end of the

Second World War. Members gave up their freedom to fix exchange rates in the interest of international cooperation, to avoid a repetition of the 1930s. During the fixed exchange rate era, lasting roughly for three decades after the end of the Second World War, the preferred option was to keep controls on cross-border movement of capital, but adopt an independent monetary policy and a managed exchange rate. The dollar alone remained convertible into gold.

As the US started incurring increasing external deficits in the 1960s partly as a result of the Vietnam War, this led to accumulation of dollars in the reserves of surplus countries. To forestall a run on its own stocks of gold, the US unilaterally withdrew its commitment to convert dollars into gold at a fixed price in 1971: this convertibility had underpinned the Bretton Woods fixed exchange rate system.

After the convertibility of dollar into gold was unilaterally suspended, there were attempts to maintain fixed exchange rates – notably the Smithsonian Agreement of December 1971. But as capital account transactions were increasingly liberalised by most advanced economies, if only in a "stop/go" fashion, it became increasingly difficult to maintain the parities. And since then the global economy has been living in the era of floating exchange rates.

To quote from the IMF's Study on Advanced Country Experiences with Capital Account Liberalization (2001):

⇒ *The United States used capital controls in the late 1960s and early 1970s in a (largely unsuccessful) attempt to stem capital outflows and avoid having to increase domestic interest rates*.

⇒ *Advanced countries have followed a variety of approaches in undertaking capital account liberalization. Most of them have taken a relatively gradual approach… Japan* (adopted a) *practice of actively varying controls on both inflows and outflows during the 1970s in response to exchange rate pressures*.

⇒ *A number of advanced economies suffered financial sector crises following capital account liberalization and financial sector reform (including Japan and some Nordic countries*)……*as the experiences of some advanced countries illustrate,* ***sound macroeconomic policies are important but not sufficient***

***to avoid exchange rate volatility** and potentially problematic capital flows*" (emphasis mine).

⇒ *By the end of the 1980s, most advanced countries had completely liberalized their capital accounts, in stark contrast to the situation in the 1960s and 1970s when most countries operated restrictive exchange control regimes*.

Even in the 1980s (and later) advanced countries have intervened in the exchange market for macroeconomic objectives. Perhaps the most successful was the so-called Plaza Agreement of 1985 calling for an appreciation of particularly the yen and the Deutsche mark against the dollar: this was needed to counteract the rising unemployment in the US. **The agreement tacitly accepted the linkage between exchange rates, current account imbalances and jobs.** There are many such instances of even advanced economies needing to "manage" exchange rates, the latest ones being Switzerland and Japan. As early as 1990, *The Economist* pronounced that the decade of the 1980s will be noted as one in which ***'the experiment with floating currencies failed'*** (issue of January 6, 1990).

Nevertheless, in the last 30 years, the model, propagated by the International Monetary Fund (and, lately, the G 20) even for developing countries, has been to have a liberal capital account and an independent monetary policy, foregoing, out of the Impossible Trinity, a managed exchange rate in favour of a market determined, or floating, one.

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