Philip R Lane: International policy trilemmas

Remarks by Mr Philip R Lane, Governor of the Central Bank of Ireland, to the London Irish Business Society, London, 31 January 2017.

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"International Policy Trilemmas"

The implications of global and regional integration for policymaking have been much studied in recent decades. Indeed, I spent 2002–2008 as Director of the Institute for International Integration Studies (IIIS), which aimed to provide multi-disciplinary perspectives on the myriad policy challenges associated with cross-border integration[1].

In relation to economic policy, three so-called trilemmas capture the tensions in determining policy choices in an integrated world economy. First, the Mundell-Fleming trilemma postulates that only two of the following three choices are simultaneously feasible: an independent monetary policy; a stable exchange rate; and unrestricted international capital mobility[2]. Among the advanced economies that largely adhere to the principle of unrestricted capital mobility, we see countries with independent monetary policies and floating exchange rates and we see countries opting for a shared monetary policy through the elimination of national currencies in the form of the European monetary union. For some major emerging economies, restrictions on international capital mobility are imposed in order to target both a stable exchange rate and some independence in domestic monetary policy.

Second, as proposed by Dirk Schoenmaker, the financial trilemma has it that only two of the following three options are possible: financial stability; independent national financial policies; and cross-border financial integration[3]. A restrictive approach to cross-border financial trade can enable a country to combine the maintenance of financial stability with purely domestic financial sector policies, while liberalisation in financial services trade typically requires considerable cross-border policy collaboration if financial stability is to be achieved, especially during periods of financial turmoil.

Third, as developed by Dani Rodrik, the political economy trilemma lays out the restrictive choices between: deep economic integration; democratic politics; and national policy autonomy[4]. At a strategic level, the institutional development of the European Union has been directed at providing sufficient democratic foundations to underpin enhanced integration across various policy dimensions, through Treaty reforms, inter-governmental mechanisms such as the European Council and an enhanced role for the directly-elected European Parliament. However, the Brexit decision now compels Europe to also develop mechanisms to foster collaboration between two entities (the EU and the UK) that will no longer be bound together by a common multi-layered institutional framework.

While the trilemma framework is perhaps too stark, it is analytically helpful to recognise the genuine tensions across inter-linked policy dimensions. Let me focus in on the monetary policy and financial trilemmas. In relation to monetary policy, Brexit does not alter the status quo, which no commitment on either side to stabilise the value of Sterling against the euro and the Bank of England and the European Central Bank each pursuing an independent monetary policy.

In relation to financial stability policies, much has already been written as to the prospects for post-Brexit financial services trade between the UK and the EU. In relation to the clearing of euro-denominated trades in the UK, President Draghi has recently pointed out that "it will be important to find solutions that at least preserve, or ideally enhance, the current level of supervision and oversight.[5]"This is important both in relation to the ECB's role as a supervisor of clearing member banks and as the central bank of issue for the euro.

More broadly, the maintenance of financial stability necessarily requires considerable bilateral and multilateral collaboration across major central banks. During the global financial crisis, this included a network of currency swap lines to facilitate access to foreign-currency liquidity, while fora such as the Bank for International Settlements and the Financial Stability Board enable the sharing of analysis and information across jurisdictions. Similarly, there is a significant degree of coordination in banking regulation through the Basel Committee. Still, there are inevitably differences of degree in terms of the scale of coordination within the EU relative to that achievable through global institutional frameworks. Let us see if some intermediate-level arrangements between the UK and the EU will be delivered through the upcoming EU-UK negotiations.

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1 This work now carries on under the umbrella of Trinity Research in Social Sciences (TRiSS), which is the successor institution to the IIIS. The work of the IIIS is archived at www.tcd.ie/iiis.

2 Maurice Obstfeld, Jay C. Shambaugh and Alan M. Taylor (2005), "The Trilemma in History: Tradeoffs Among Exchange Rates, Monetary Policies and Capital Mobility," *Review of Economics and Statistics* 87(3), 423–438.

3 Dirk Schoenmaker (2011), "The Financial Trilemma," *Economics Letters* 111, 57–59.

4 Dani Rodrik (2011), *The Globalization Paradox: Democracy and the Future of the World Economy*, WW Norton.

5 Letter from the ECB President to Ms Perevenche Beres, MEP, on the legal framework for central counterparties, 11 January 2017.