Comments on Obstfeld, “Trilemmas and Tradeoffs: Living with Financial Globalization”

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Objectives and background

- The paper's takeaway
  - Adopting the floating exchange rate regime helps solve the traditional monetary policy trilemma (impossible trinity). However, its power is constrained by a "financial policy trilemma": the incompatibility of national responsibility for financial policy, international financial integration, and financial stability
  - a more difficult tradeoff among multiple objectives, the result of a shortage of reliable policy instruments for attaining those objectives simultaneously
- Background
  - QE2 and spillover
    - Currency wars (2010)—Finance Minister Mantega
    - Competitive QE (2014)—Governor Raghu Rajan
  - Global liquidity and synchronous credit cycles (2011-13)
  - Taper tantrum and "credit reversal" (2013-)

Two types of trilemma: monetary and financial

Monetary trilemma (impossible trinity)

autonomous monetary policy		yes	yes	no
fixed exchange rate		yes	no	yes
free capital mobility		no	yes	yes
		China	Thailand, Indonesia	Hong Kong

Financial trilemma (Obstfeld)

national financial policy		yes	yes	no
internation financial integration		yes	no	yes
financial stability		no	yes	yes

Comment #1: How serious is financial trilemma?

		(case A)	(case B)	(case C)
national financial policy		yes	yes	no
internation financial integration		yes	no	yes
financial stability		no	yes	yes

- (Case A) Did any country fall into financial instability due to the trilemma?
  - Korea, 2009—capital outflow and liquidity shortage
- (Case B) NOT fully integrated to global financial markets
  - Most Asia EM – China, Thailand, Malaysia, Indonesia
- (Case C) No national financial policy?
  - Any example? Does subscribing to Basel III mean no national financial policy?
- (QUESTION) Is this really a trilemma? Can each country not choose Macro-prudential policy?

Comment #2: New problem or old problem?

- “Too much capital flows and sudden reversal” is not new
  - Most EM crises occurred when the US raised the interest rate—1980s LatAm crisis; 1994 Mexican crisis
  - So what is the difference in the QE world?
    - (My guess) QE’s main channels are perceived to be the exchange rate and the asset prices
    - Is this correct?

Comment #3: Prevention is better than management

- Capital inflow stage and outflow stage should be separately discussed
- Questions: True or false?
  - Hypothesis: “If too much capital inflows are managed well, sudden reversal can be managed easily”
    - A bit of appreciation, intervention and accumulation of reserves, Chilean-type withholding tax on short-term inflows, LTV and other Macro-Pru, fiscal consolidation (to mitigate overheating)
    - IMF advices should be during the inflow stage (whentime is good)
  - Hypothesis: “If financial supervision and macro-pru is perfect, then monetary policy can be FIT (no lean-against a la White-Borio) and no monetary policy-financial stability tradeoff”

Asian (ex-Japan) solution

- Decisively "middle-ground" in managed float
  - Never believed in a two-corner solution (hard peg or free float)
  - Exception, Hong Kong
- Self-insurance
  - Rapid increase in foreign reserves, 2000-2007
  - Used some to mitigate depreciation in 2008-10
  - Resume increases since 2010
- Macro-Prudential policies (at least attempts)
  - LTV, direct credit control,
- Keep capital controls
  - Not fully integrated in global financial markets

Conclusion

- Although it may require a different paper, I would like to see more discussions on
  - Benefit of intervention and accumulation of foreign reserves (as a buffer)
  - Types and effectiveness of macroprudential policies and capital controls that can be adopted by EM
  - Measures against too much capital inflows and sudden stop/reversal