The impossibility of the impossible trinity? The case of Indonesia

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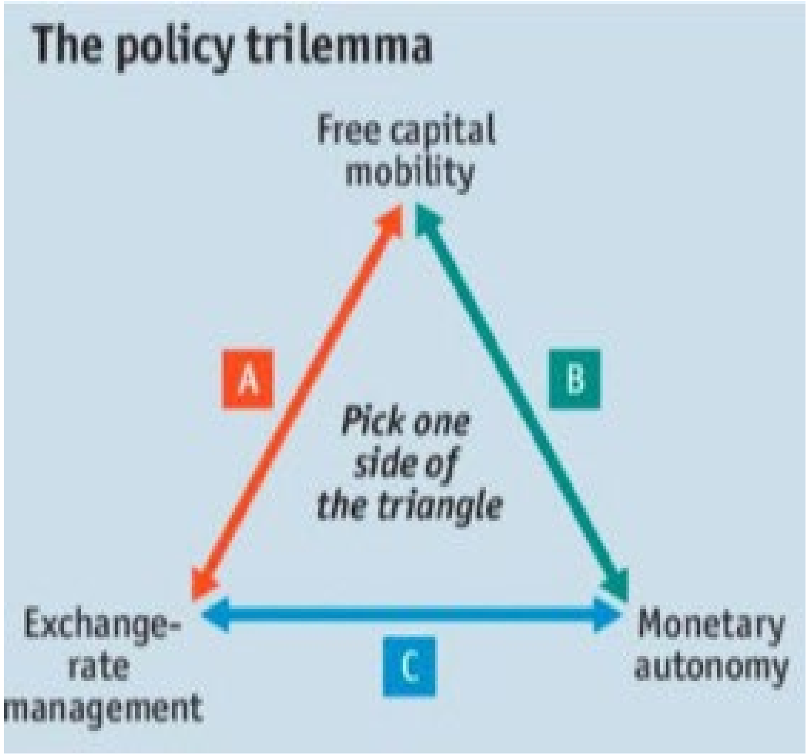
Background and Questions to be addressed

- Large capital flow disruptions also create significant challenges and issues for policy-makers in emerging markets and developing economies (EMDEs) (see Grenville's paper)
- This paper looks at Indonesia's experiences from the 2009 QE and the 2013 taper tantrum, why Indonesian policy-makers were unable to use policies as per the trilemma, and the policy implications of this.
- This issue is particularly relevant today, especially with the interest hike in the US
- Does the trilemma (impossible trinity) work for Indonesia?
- How can policy-makers manage capital flows if the impossible trinity does not function as predicted?

Trilemma vs Dilemma



Source: Economist.com

Dilemma (Rey, 2013)

- Global financial cycle: countries cannot fully insulate themselves from external shocks
- The importance of financial stability: Financial stability is crucial, but it may require sacrificing some degree of monetary policy independence.
- The role of capital flows: Rey argues that capital flows can be both beneficial and disruptive to an economy.
- The limits of exchange rate management: While a flexible exchange rate can help insulate an economy from external shocks, it may not be enough to prevent financial instability. Furthermore, exchange rate management can be costly and difficult to implement, especially in the face of large and volatile capital flows.
- Therefore, countries must consider a range of policy options when dealing with the dilemma, including macroprudential regulation, capital controls, and coordination with other central banks.

Managing capital flows

Exchange rate not undervalued

(a)
Lower rates /
Rebalance policy mix
Unsterilized intervention

(b)
Lower rates /
Rebalance
policy
mix

(c)
Capital
flow
management
measures

(d)
Sterilized
intervention

(e)
Appreciate
Lower rates /
Rebalance
policy
mix

(f)
Appreciate

(g)
Appreciate
Sterilized
intervention

Reserves adequate

Economy overheating

Notes: Each circle represents cases where the relevant condition is met. For example, the top most circle ("Exchange rate not undervalued") represents cases where the exchange rate is assessed to be broadly in line with fundamentals or overvalued. The intersection of all three circles (the area marked "c")—where use of capital flow management measures may be appropriate—reflects cases where the exchange rate is not undervalued, reserves are judged to be adequate, and the economy is overheating. Other intersections similarly represent other confluences of factors. For example, the top left intersection (area "b") represents cases where the exchange rate is not undervalued, reserves are judged to be adequate, and the economy is *not* overheating (since the case is outside the "Economy overheating" circle). Areas of no intersection represent cases where one of the circles—but not the other two—is applicable. For example, the bottom right area ("g") represents cases where the economy is overheating, the exchange rate is assessed to be undervalued, and reserves are judged to be inadequate. "Lower rates / Rebalance policy mix" refers to loosening monetary policy; to the extent that fiscal policy is tightened, there would be more room to lower policy rates.

Exchange rate undervalued/
Balance sheet FX exposure high

Raise rates/
Intervene

Raise
Rates

Intervene
+ Sterilize

(c)

Depreciate
/ Raise
Rates

Depreciate

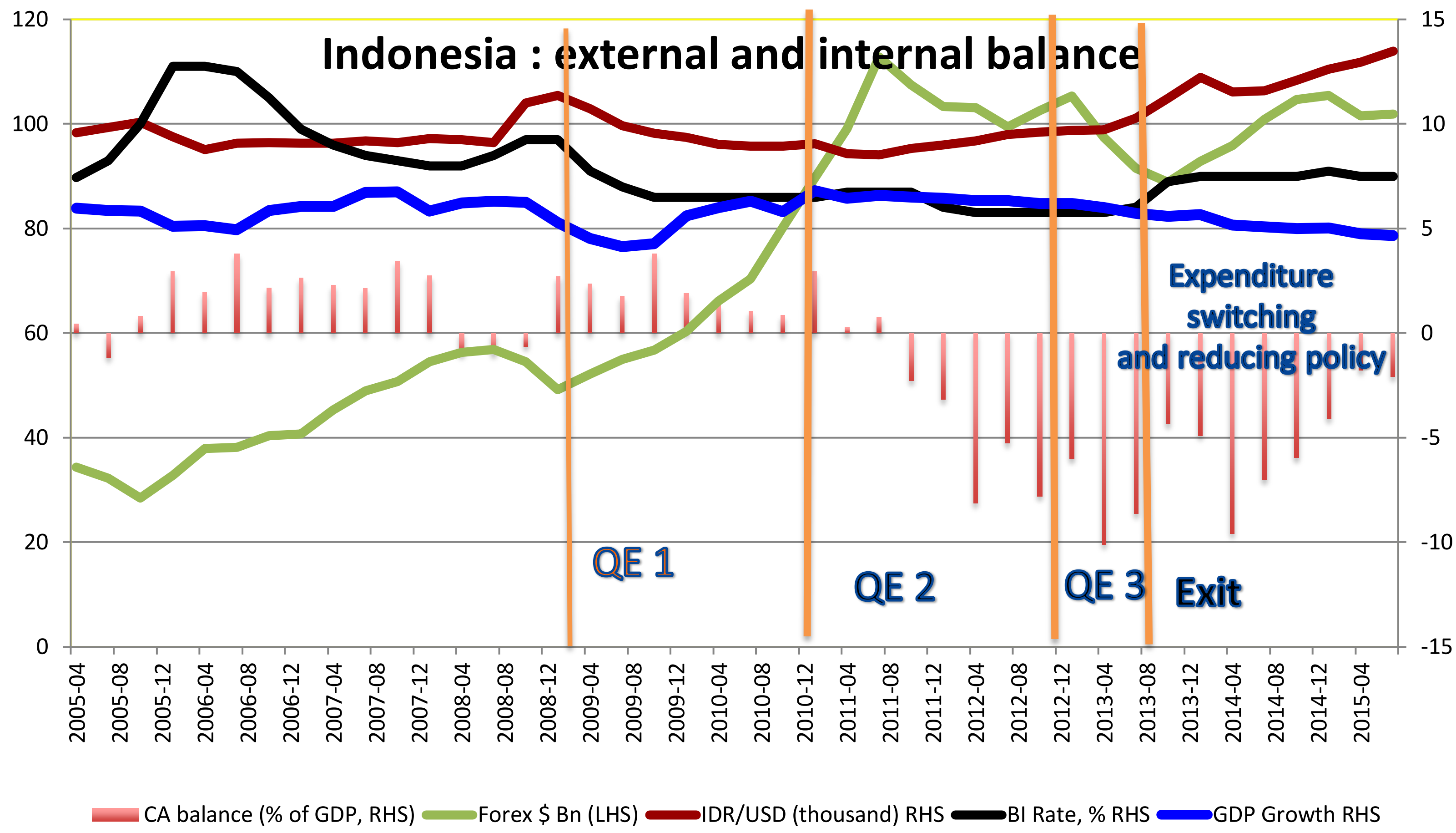
Depreciate /
Intervene +
Sterilize

Reserves inadequate

Economy stagnating

A country in (c) may be in crisis or imminent crisis

QE and Taper Tantrum: impact on Indonesia



Why it is difficult to implement trilemma?

- Differing monetary policy objectives: full employment and trade balance
- Volatile exchange rate: exchange rate overshoot and trauma Asian Financial Crisis
- Balance sheet effects (see Shin's paper)

Role of commodity super cycle: Fiscal Policy and Procyclicality

- The role of fiscal policy in capital flows
- Procyclicality and fiscal policy
- The Distributional effect of commodity super cycle
- Income redistribution effect and fiscal procyclicality

Monetary policy on its own is likely to been insufficient to manage the economy adequately.

The mix of —monetary policy, macroprudential policy, and fiscal policy—becomes essential.

Capital Flow Management: needed but must be careful

- Capital flow management should not be considered a panacea.
- Forbes, Fritzsche, and Straub (2015)capital flow management can improve measures linked to financial fragilities, little significance in affecting equity indices, inflation, interest-rate differentials, or the volatility of exchange rates, portfolio flows, or interest-rate differentials in the short and medium term.
- Capital flows are beneficial only after a country has reached a certain amount of institutional or financial sector development
- Role of institution: the strength, trust, agility, and capability of the institutions in a country are key factors in its ability to respond to capital volatility.
- FDI and investment climate

Thank you