Impossible Trinity of Monetary Policy

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In news

The Impossible Trinity is pushing the Reserve Bank of India toward a stronger rupee

What is Impossible Trinity or Trilemma?

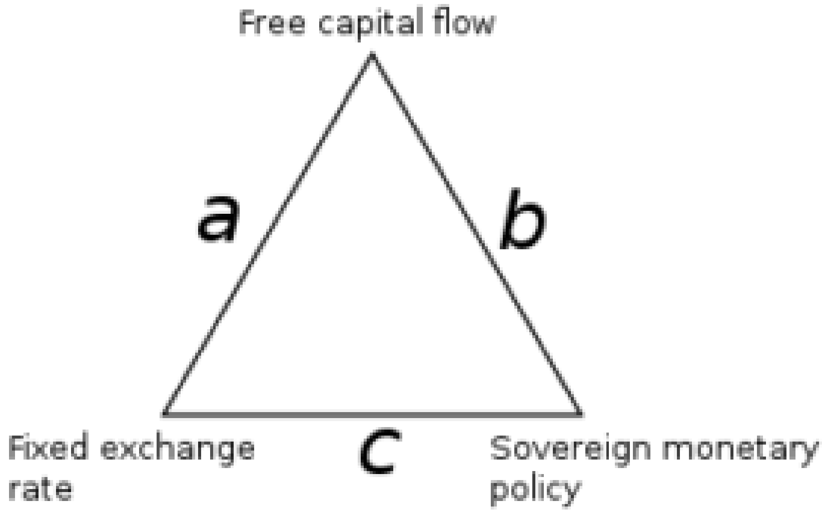
Impossible trinity or trilemma in monetary policy means that a country cannot have a fixed exchange rate, free movement of capital and an independent monetary policy at the same time.

As it happened in India, after lowering interest rates over the last one year, RBI went ahead to protect the rupee by sucking liquidity out of the system, which has resulted in higher cost of money and higher interest rates.

From a pure monetary policy standpoint, RBI had no intention of raising interest rates. In fact there was a case to cut policy rates to support growth, but while targeting currency it lost a bit of control on the monetary policy, which resulted in higher interest rates.

The trilemma is a concept of economics which states that it is impossible to have all three of the following at the same time:

- a fixed foreign exchange rate
- free capital movement (absence of capital controls)
- an independent/sovereign monetary policy



Free capital flows: The first part, free capital flows refer to the movement of money for the purpose of trade and investment, including the flow of capital usually in the form of investment capital.**Fixed exchange rate:** The second, a fixed exchange rate (or pegged exchange rate), is a kind of exchange rate regime where a currency's value is fixed against the value of another currency, or to another measure of value such as gold. This regime is usually used to stabilise the value of a currency.
Sovereign monetary policy: The third and final part is a sovereign monetary policy also known as independent monetary policy. A monetary policy is the process by which the monetary authority, usually the central bank of the country controls the supply of money.

Who developed this model?

The concept was developed independently by both **John Marcus Fleming** in 1962 and **Robert Alexander Mundell** in different articles between 1960 and 1963. It is a hypothesis based on the interest rate parity condition and empirical studies have proved that any country attempting to achieve the impossible trinity, is bound to fail.

More about this model

- Trilemma often is synonymous with the “impossible trinity,” also called the Mundell-Fleming trilemma.
- This theory exposes the instability inherent in using the three primary options available to a country when establishing and monitoring its international monetary policy agreements.
- Trilemma which posits that countries may choose from three options when making fundamental decisions about their international monetary policy agreements.
- According to the impossible trinity, a central bank can only pursue two of the above-mentioned three policies simultaneously.
- However, only one option of the trilemma is achievable at a given time, as the three options of the trilemma are mutually exclusive.