RBI and Impossible Trilemma

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Impossible Trinity/trilemma

- The combination of an open capital account, a fixed exchange rate, and an independent monetary policy – the ‘impossible trinity’ – is not feasible.
- Countries can attain any two of these three objectives but not all the three simultaneously. Thus, with an open capital account and an affixed exchange rate, an independent monetary policy is not possible. On the other hand, the pursuit of an independent monetary policy will require a country to accept either a closed capital account or a flexible exchange rate, but not both.
- India has so far not attempted to manage all three factors. The country currently follows an independent monetary policy but it follows a mid-path in controlling the other two.
- The currency is partly managed and certain capital flows are freely allowed while others are restricted. This has worked alright until now.
- Even if the RBI cuts its policy rates to suit domestic needs, the outflow of funds is limited due to the restraints on capital flows. The currency is also not that greatly affected.
- But the RBI has made it clear that it would like to move towards full convertibility over the long-term. If that happens, RBI may not be able to maintain a tight rein on interest rates.
- An independent monetary policy will be difficult given that rupee is nowhere close to becoming a reserve currency like the dollar.