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Is Malaysia exempted from the impossible trinity? An empirical analysis for an emerging market

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This paper estimates offset and sterilization coefficients in Malaysia with the objective to assess the relevance of the Impossible Trinity for policy. The paper finds that Malaysia had scope for independent monetary policy in the short run; but in the longer run only under managed floating or capital controls. The loss of long-run monetary autonomy under peg/open capital was in line with the trinity, and may be one reason the peg was eventually abandoned for managed floating in year 2005. The results suggest that managed floating with sterilizations could be a viable monetary strategy for emerging markets facing volatile capital flows.

Keywords: offset coefficient; sterilization coefficient; monetary autonomy; impossible trinity; Malaysia

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1. Introduction

The choice of exchange rate regime is a key policy decision for small, open economies. Many such economies prefer stable rates which reduce transactions costs, exchange risks and provide a nominal anchor for monetary policy.[1] However, these benefits come with a cost because stable rates (as in a peg to a base currency) could restrict the policy options of an economy. A well-known principle often called the 'trilemma' postulates that a small economy can implement only two out of these three policy options: a peg, an open capital account or an independent monetary policy. The trilemma's reasoning is as follows: with a peg and an open capital account, the country has to keep its domestic interest rate aligned with the base country interest rate, adjusted for risks; if the country's interest rate deviates from the base interest rate, the resulting interest gap would only stimulate investment flows that would then reinforce interest parity. Hence, an economy choosing an exchange peg can subsequently choose to keep either an open capital account or an independent monetary policy; but not both.

Historically, however, policymakers seemed ambivalent about the trinity's relevance; heeding the constraints at times, but not at others. In the mid-1980s, most developing countries chose discretionary monetary policy, stable exchange rates, and relatively closed capital accounts, consistent with the trinity. In the early 1990s, many such countries embraced financial liberalization and began to open their capital accounts, but they tended to stick with pegged rates and discretionary monetary policy as before – a mix

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