

Testing the trilemma: exchange rate regimes, capital mobility and monetary independence

Abstract

Previous research on the incompatibility of a pegged exchange rate, capital mobility, and monetary independence (the open-economy trilemma), based on the degree to which domestic interest rates follow foreign rates, has produced mixed results. Despite its centrality to other areas of investigation, such as currency crises, the role of the credibility of the peg has hitherto been ignored. Fluctuations in perceived devaluation probabilities will move domestic interest rates, given foreign interest rates, even if countries have no genuine monetary independence. Using data for 126 countries from 1990, it is shown that countries on credible pegs without capital controls follow foreign interest rates closely, and that the hypothesis of complete lack of monetary independence cannot be rejected in this case. Our findings are robust to alternative measures of credibility (inflation differentials; types of peg), and to different ways of classifying exchange rate regimes and identifying capital controls.