UNIVERSITY OF THE PEOPLE

BUS 2203-01 Principles of Finance 1 – AY2024-T2

Learning Journal Unit 7

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Introduction

Chapter 19 examines the challenges countries face in balancing international capital mobility, exchange rate stability, and independent monetary policy. Known as the "impossible trinity" or "trilemma", countries must give priority to two of these policy goals while sacrificing the third (Wright & Quadrini, 2009). The chapter outlines four major international monetary regimes and their tradeoffs.

Summary

The "impossible trinity" means countries can only maintain two of the following at any time: free capital mobility across borders, a fixed exchange rate, and an independent monetary policy. To keep exchange rates fixed, central banks give up control of domestic interest rates and money supply or impose strict capital controls. Alternatively, floating exchange rates allow autonomy in setting monetary policy and financial openness but bring exchange rate volatility (Wright & Quadrini, 2009).

Historically, the classical gold standard provided fixed rates and capital mobility but no monetary policy discretion. Bretton Woods provided domestic policy control and stable rates via capital restrictions. Today's predominant free float regime restores capital mobility but allows variable exchange rates. Managed floats attempt to get the best of both worlds by allowing rates to fluctuate within bands, intervening when rates approach band edges. Pegged rates help developing countries import monetary credibility and price stability but pegs frequently collapse. Crawling pegs and wide bands provide more flexibility with still some rate stability.

Countries make tradeoffs between policy priorities according to their economic and political objectives. The optimal regime depends on institutional quality, development level, susceptibility to shocks, financial openness, and other factors. There is no universal best regime.

Conclusion

The impossible trinity dictates all nations must make difficult choices balancing conflicting policy goals. Understanding the inherent tradeoffs empowers countries to choose arrangements suited to their economic conditions and priorities.

Reference:

Wright, R.E. & Quadrini, V. (2009). Money and Banking. Saylor Foundation.

Word count: 289