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The political economy of the impossible trinity☆

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ABSTRACT

This paper reconsiders the policy trilemma in an open economy by incorporating political economy concerns. We argue that the impact of government ideology on monetary independence, exchange rate stability, and capital flow restrictions should be analyzed in the broader context of restrictions imposed by the impossible trinity instead of the usual single-dimensional constraints. Employing a de facto measurement of these restrictions for a sample of 111 countries from 1980 to 2010, we show that the impact of government ideology on a country's position in this trilemma is highly context dependent: we find that its impact on exchange rate stability and monetary independence varies between developed and developing countries. We also show that the impact of government ideology on these two trilemma components is contingent on the stance of the respective economy's business cycle. Left-leaning governments seem to favor exchange rate stability over monetary independence in case of a negative output gap; suggesting a reversal of their commonly assumed partisan preferences in economically tight times.

1. Introduction

The question of whether government ideology matters for various macroeconomic policies in an open economy has attracted a great deal of interest among researchers (see, for instance, Potrafke, 2016; Ellis and Thoma, 1996; Oatley, 1999). Next to reelection considerations (opportunistic cycles), partisan preferences of policymakers might shape the conduct of macroeconomic policies, resulting in so called partisan political business cycles.

Previous studies have, for instance, analyzed the impact of ideology on monetary and exchange rate policy. One hypothesis is that left-wing governments have a higher preference for inflation and flexible exchange rates than right-wing governments (Alesina, Roubini and Cohen, 1997; Drazen 2000). Left-wing governments might aim at exploiting a short run Phillips curve trade-off when conducting monetary policy, which eventually results in higher inflation (Barro and Gordon, 1983, Kydland and Prescott, 1977). In a similar fashion, it has been argued that left-wing governments increase the likelihood of a flexible exchange rate regime in order to bolster exports through depreciations (Chang and Lee, 2013).

In order to investigate monetary policy effects, early studies in the 1980s and 1990s used money supply growth, inflation, and - in

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a few cases - also official interest rates as “policy instruments” to test whether ideology indeed matters for conducting monetary policy.[1] Recognizing the importance of the monetary transmission mechanism, Belke and Potrafke (2012) also focus on the time pattern of interest rates according to the Taylor Rule and find a significant impact of ideology on monetary policy. This result seems remarkable since a strong prior emerged in the profession that the partisan cycle must be dead in times of inflation targeting - the monetary policy dogma prevailing in the paper's sample period preceding the financial crisis.

Whether partisan preferences can translate into macroeconomic policies in the first place depends on the various economic, institutional, and political contexts a policymaker operates in (cf. Steinberg and Walter, 2013). A key suggestion for eliminating partisan or opportunistic inflation biases, for example, has been to increase the degree of central bank independence as a formal constraint to government interference (De Haan, Masciandaro and Quintyn, 2008). Some institutional choices, however, also affect the availability of other policy instruments. One example is a country that joins a monetary union and effectively gives up monetary independence to achieve fixed exchange rates.

Despite analyzing several samples and countries, an important shortcoming of many previous studies is that they neglect such a trilemma problem in an open economy, in which a government faces several simultaneous policy choices. According to the impossible trinity hypothesis, a fixed exchange rate regime, free capital flows, and monetary independence cannot be achieved simultaneously. Only two of those aims can be realized at the same point in time (Fleming, 1962; Mundell, 1963). The fact that some emerging economies still rely on fixed exchange rates and restricted capital flows to allow for a certain degree of monetary independence illustrates the importance of such a distinction (Fratzscher, 2012). Analyses of monetary policy independence, however, often neglect the influence of exchange rate fluctuations and the freedom of capital account flows (see, for instance, Obstfeld et al., 2004). In the same vein, papers that analyze the political economy of exchange rate regimes often neglect de facto degrees of monetary independence (see, e.g., Berdiev et al. 2012; Setzer, 2006) or capital flow restrictions (see Willett, 2004). Unlike central bank independence that captures the formal independence of central banks from their respective governments, de facto monetary independence means independence from interest rates of other countries. Modelling macroeconomic policy choices with respect to only one of the trilemma variables runs the risk of producing biased results due to misspecification.

Against this background, this paper asks how partisan preferences affect the positioning of a country in this trilemma and analyzes the impact of ideology on the degree of monetary independence and exchange rate stability, as well as on capital flow restrictions in the context of these trilemma restrictions. Importantly, it works in a framework, in which all three trilemma dimensions are endogenous. In addition, while previous research usually takes into account some kind of relationship between exchange rates and monetary policy, for example, by considering the exchange rate regime when analyzing monetary policy, an explicit analysis of the drivers of a country's position with regard to the *de facto* trilemma is still missing. The few studies that consider trilemma restrictions rely on formal classifications of de jure exchange rate regimes, central bank independence, or capital flow restrictions (Berdiev et al., 2012); which may not necessarily match the de facto restrictions that a policymaker faces when making her interdependent choices. This is due to the fact that a country's formal central bank independence, for instance, does not necessarily imply its de facto monetary independence: a formally autonomous central bank, for example, is still subject to international constraints when setting interest rates depending on the degree of exchange rate stability and flexibility in place.

As opposed to de jure, categorical measures, continuous measures that rely on dyadic relationships between countries are able to capture these more fine-grained de facto constraints. Against this background, we rely on the Aizenman et al. (2010, 2013) trilemma index which mirrors the *effective* independence of monetary and exchange rate policy and the freedom of capital flows. Their measure for exchange rate and monetary independence is based on standard deviations from and correlations with an anchor currency or interest rate. Applying a de facto rather than a de jure classification has the advantage that estimated coefficients can thus also capture the partisan effect on de facto monetary independence or exchange rate stability, while effects on domestic interest rates or a de jure exchange rate classification do not necessarily allow for such a conclusion.

Apart from these trilemma constraints, we also analyze how business cycle dynamics affect the way in which partisan preferences translate into different degrees of monetary independence, exchange rate stability, and capital flow restrictions and thereby add to an increasingly rich literature on contingent partisan effects.

In order to consider the trilemma problem properly, we simultaneously estimate equations determining the degree of monetary independence, exchange rate stability, and capital flow restrictions in a three-stage least squares (3SLS) approach. In addition, we run a K-means cluster analysis based on the three measures provided by Aizenman et al. (2010) to identify country groups that represent similar trilemma policy regimes. Levy-Yeyati and Sturzenegger (2005) adopt a related approach in the context of exchange rate regime classification. This approach allows us to study whether the impact of partisan preferences on specific trilemma positions systematically varies across countries that lean towards a certain trilemma regime. As a robustness check and comparison to our classification, we estimate sample splits along a formal distinction of OECD and non-OECD countries. We also analyze subperiods and consider fixed effect estimates as further robustness checks.

The remainder of the paper proceeds as follows. Section 2 provides a literature review. Section 3 describes the data, the empirical model, and the econometric methodology. Section 4 summarizes the empirical findings and Section 5 concludes.

[1] Belke and Potrafke (2012) summarize three possibilities available to governments to affect monetary policy: nomination of the council members (Galbraith et al., 2007; Lohmann, 1998; Vaubel, 1993, 1997a, 1997b; Berger and Woitek, 1997), signalling (Havrilesky, 1988, 1991; Sieg, 1997), and bashing and coercion (Lohmann, 1998; Waller, 1991).