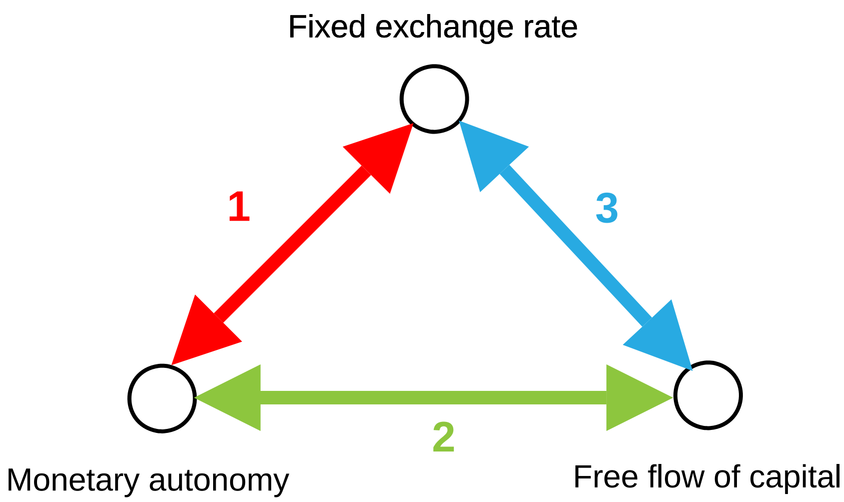
The policy trilemma

Source: The Mundell-Fleming trilemma: Two out of three ain't bad, www.economist.com (26.8.2016)

I The **trilemma** or the **impossible trinity** describes a situation where only two of three policy goals are possible:



II **Example** of an impossible trinity:

Suppose a country with a fixed exchange rate and free flow of capital (3). Then, the central bank of this country lowers the interest rates massively (as if monetarily autonomous). Capital would leave the country in search of higher returns. To maintain the fixed exchange rate, the central bank would be obliged to intervene: Sale of foreign currency against own currency. For how long? Result: Monetary autonomy is not possible.

III As the graph indicates, there are **three possibilities**:

1 Fixed exchange rate and monetary autonomy (**no** free flow of capital)

2 Monetary autonomy and free flow of capital (**no** fixed exchange rate, but flexible exchange rate)

3 Fixed exchange rate and free flow of capital (**no** monetary autonomy)

IV If a **free flow of capital** is desirable, the trilemma is reduced to the following **choice**:

Either: Fixed exchange rate and no monetary autonomy (countries of Euro-area)

or: Flexible exchange rate (instead of fixed ...) and monetary autonomy (GB)