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HOW CAN AN ECONOMY PROTECT ITSELF FROM THE DEVELOPED ECONOMIES' MONETARY POLICY?

Abstract:

In theory, countries with floating exchange rates and perfect capital mobility should have monetary independence. At the other extreme, countries with pegged exchange rates may completely lose monetary independence. This is the open-economy trilemma. Countries are not possible to combine exchange rate stability, capital mobility and monetary independence. However, previous research on the effects of the choice of exchange rate regime on monetary independence has found mixed results. Given a large set of countries, their different country characteristics such as the level of economic development may have an impact on the interest rate pass-through. In explaining the link between economic development and interest rate pass-through, business cycle synchronization could be one of the plausible reasons. If a country's business cycle is highly synchronized with foreign countries, its domestic interest rates may be highly correlated with foreign interest rates, even for countries with floating exchange rates. This complicating factor has been ignored in previous work. Thus, this study aims to re-examine this issue by incorporating the level of economic development. In doing so, this study has distinguished more developed from less developed countries. Using panel data analyses, this study uses a sample of more than 100 countries from 1995. The dataset comprises interest rates and the indicators of exchange rate regime, capital control and economic development. This study uses interest rate pass-through as the appropriate measure of monetary independence. The findings show that pegged exchange rates with no capital controls have lower monetary independence than all other regimes. In line with the theory, this study has indicated that countries will completely lose their monetary independence only if their exchange rates are rigidly pegged without capital controls. More importantly, the findings have further confirmed that the evidence of the trilemma did not differ according to sub-groups of similar level of economic development.

Keywords:

Monetary Independence, Exchange Rate Regime, the Open-Economy Trilemma

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