Trilemma Policy Convergence Patterns and Output Volatility

Joshua Aizenman
University of California, Santa Cruz
National Bureau of Economic Research
Hong Kong Institute for Monetary Research

and

Hiro Ito
Portland State University

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Summary

A fundamental contribution of the Mundell-Fleming framework is the impossible trinity (or the Trilemma), stating that a country may simultaneously choose any two, but not all of the following three policy goals—monetary independence, exchange rate stability and financial integration. Previous works by Aizenman, Chinn, and Ito developed a set of "trilemma indexes" that measure the degree of achievement in each of the three policy choices for a wide coverage of countries and years. Using the indexes, they empirically validated a continuous version of the Trilemma, showing that the three measures of the trilemma are linearly related to each other.

In "Trilemma Policy Convergence Patterns and Output Volatility," Aizenman and Ito apply these Trilemma indexes, studying the policy choices taken by emerging market economies (henceforth EMs). These countries account for 40% of the global population and have been growing at a much faster rate than all other countries during the last few decades. Aizenman and Ito construct an index of divergence of the Trilemma policy choices during 1970–2009. They find that the three Trilemma policies of EMs are converging towards a "middle ground" configuration—managed exchange rate flexibility underpinned by sizable holdings of international reserves, intermediate levels of monetary independence, and financial integration. EMs with more converged policy choices tended to experience smaller output volatility in the last two decades.

EMs with relatively low international reserves/GDP experienced higher levels of output volatility when they chose a policy combination with a greater degree of policy divergence, while this heightened output volatility effect did not apply to economies with relatively high international reserves holdings. This generalization is also true for emerging market economies during the period around the global financial crisis of 2008-09. In the 2005-09 period, economies with high levels of international reserves holding did not faced the positive correlation between policy divergence and output volatility, while the correlation is quite evident for those economies which did not hold high levels of international reserves. Given the large increases in reserves/GDP ratios for many EMs over the last decade, these observations may account for the relative resilience of EMs during the 2008–2009 crisis.