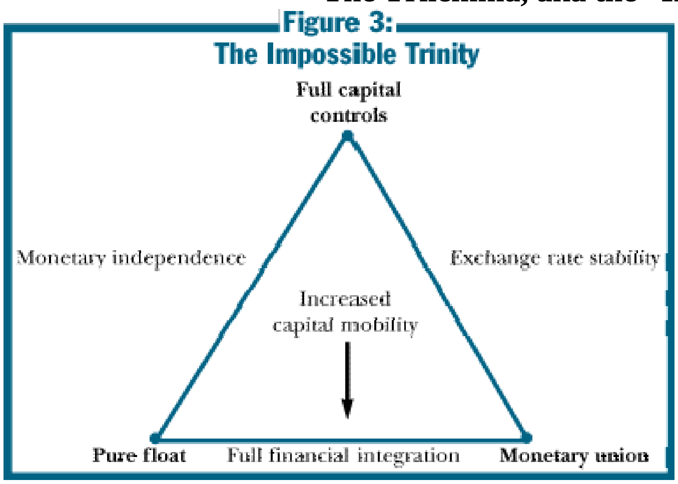
Public Affairs 854
Spring 2013
University of Wisconsin-Madison

Menzie D. Chinn
Social Sciences 7418

The Trilemma, aka the "Impossible Trinity"



http://www.brookings.edu/papers/1999/06development_frankel.aspx

Figure 1:

Definitions of Nine Major Exchange Rate Regimes, Ranged Along the Continuum from the Most Flexible to the Strongest Fixed-Rate Commitment

FLEXIBLE CORNER

1. Free floating--the absence of regular intervention in the foreign exchange market
2. Managed float--the absence of a specific target for the exchange rate

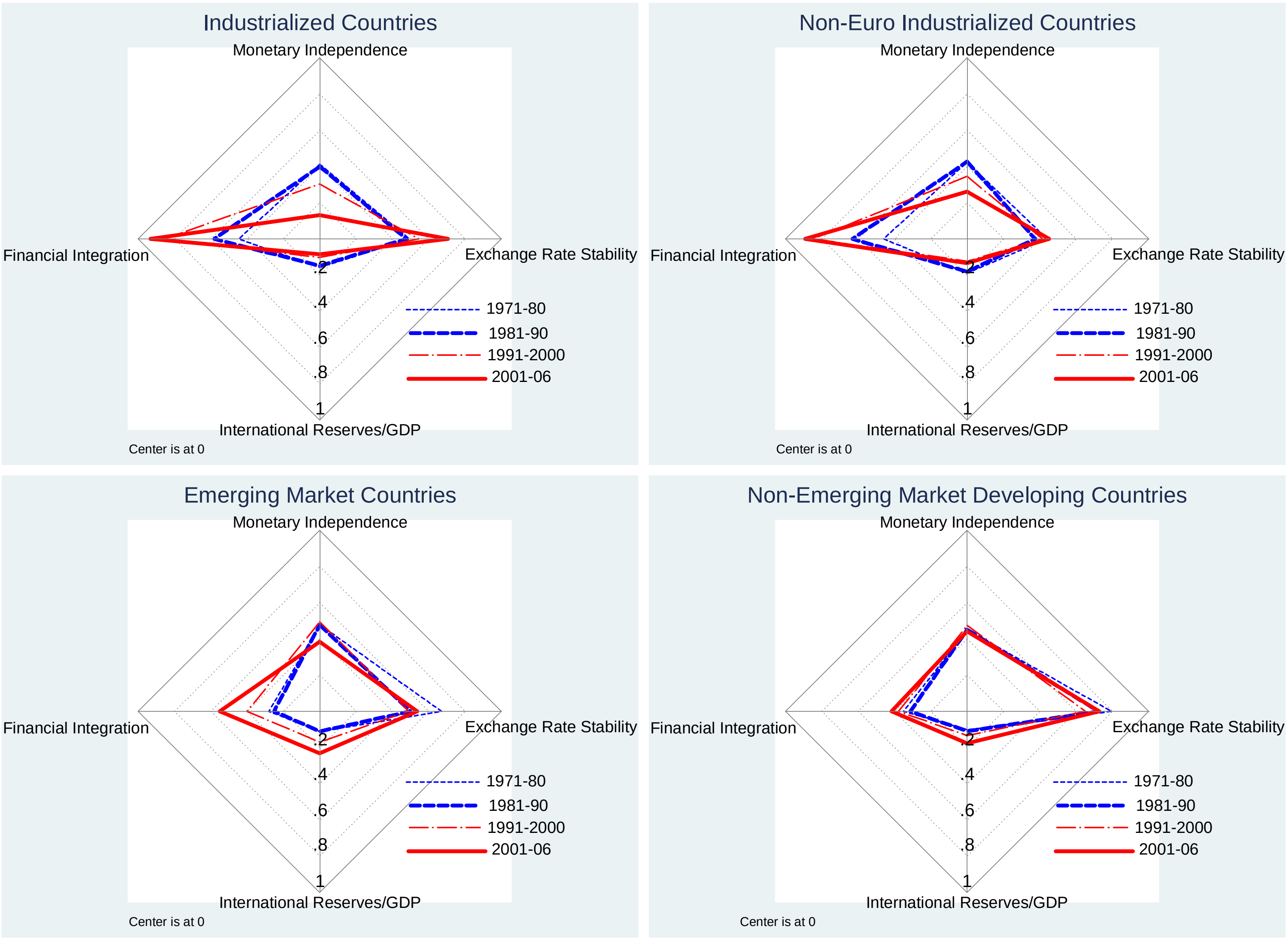
INTERMEDIATE REGIMES

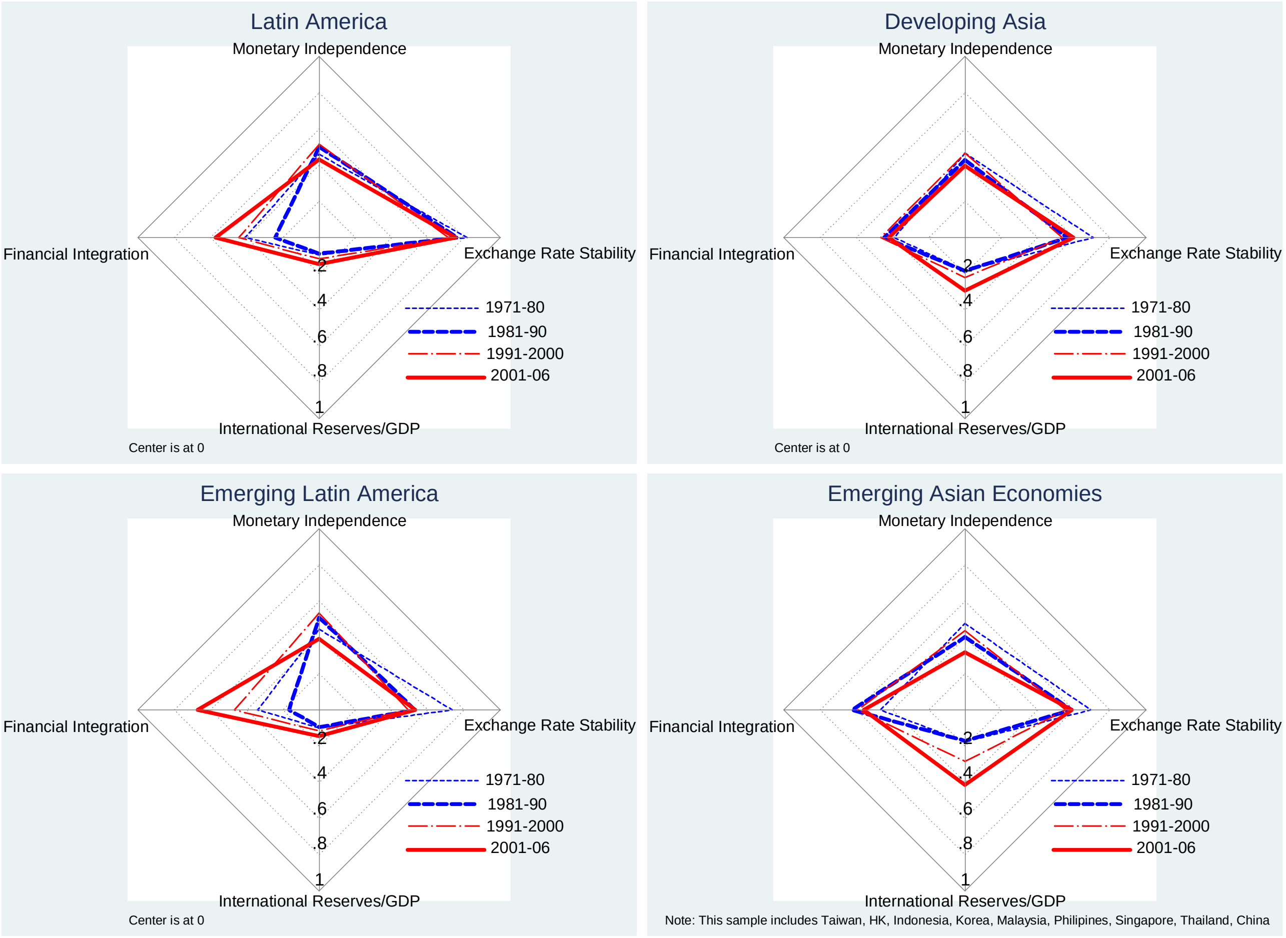
3. Target zone, or band--a margin of fluctuation around some central rate
4. Basket peg--fixing not to a single foreign currency but to a weighted average of other currencies
5. Crawling peg--a preannounced policy of devaluing a bit each week
6. Adjustable peg--fixing the exchange rate, but without any open-ended commitment to resist devaluation or revaluation in the presence of a large balance of payments deficit or surplus

FIXED CORNER

7. Truly fixed peg--fixing, committing to buy or sell however much foreign currency is necessary at a given exchange rate, with a firm and lasting intention of maintaining the policy
8. Currency board--three defining characteristics: fixing not just by policy but by law, backing increases in the monetary base one-for-one with foreign exchange reserves, and allowing balance of payments deficits to tighten monetary policy and thereby adjust spending automatically
9. Monetary union--the adoption of a foreign currency as legal tender. This includes the special case of official dollarization

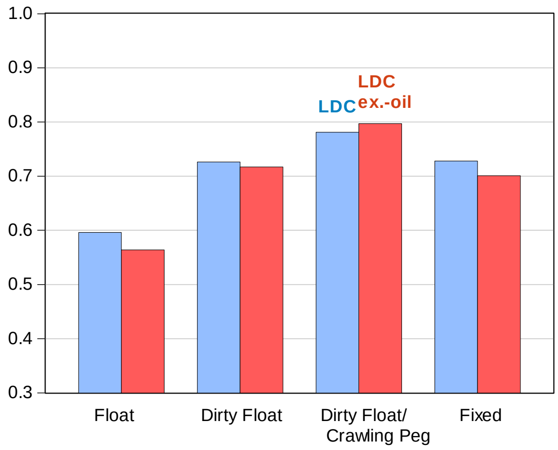
Figure 1: The Trilemma and International Reserves Configurations over Time





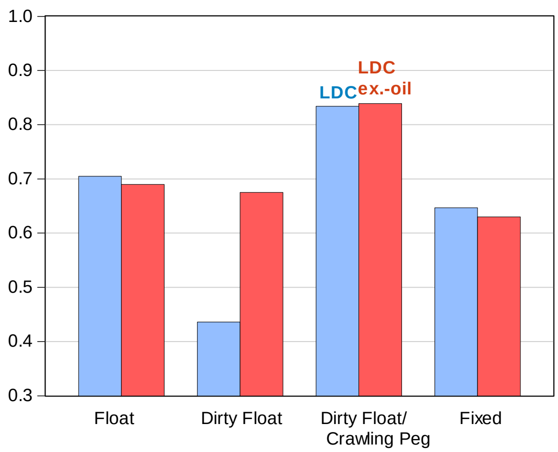
NOTES: "Emerging Asian Economies" include China, Hong Kong, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan, and Thailand. "Emerging Latin America" includes Argentina, Brazil, Chile, Colombia, Ecuador, Jamaica, Mexico, Peru, Trinidad and Tobago, and Venezuela.

Source: Aizenman, Chinn, and Ito, "The Emerging Global Financial Architecture," *mimeo* (March 2009).

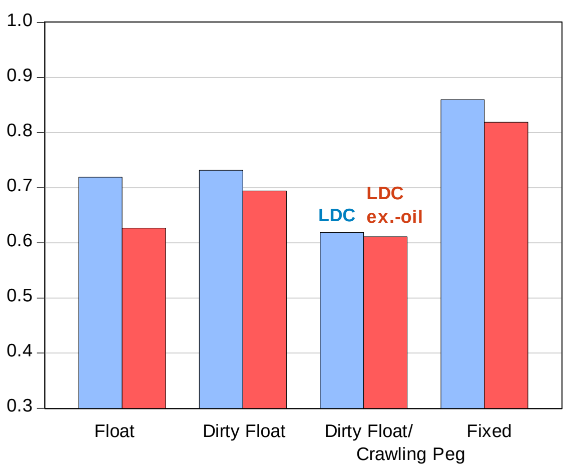


$$ca_{it} = \rho_0 + \rho_1 ca_{it-1} + v_{it}$$

AR1 coefficients for CA/GDP



AR1 coefficients for CA/GDP, with openness as covariate



AR1 coefficients for real effective exchange rate, with openness as covariate

Source: Chinn and Wei, "A Faith-based Initiative: Do We Really Know that a Flexible Exchange Rate Regime Facilitates Current Account Adjustment?" *mimeo* (March 2009).