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Surfing the waves of globalization: Asia and financial globalization in the context of the trilemma

Joshua Aizenman [a,b], Menzie D. Chinn [c,b,*], Hiro Ito [d]

[a] Department of Economics, University of California, Santa Cruz, United States
[b] National Bureau of Economic Research, United States
[c] School of Public Affairs and Department of Economics, University of Wisconsin, United States
[d] Department of Economics, Portland State University, United States

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ABSTRACT

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Using the "trilemma indexes" developed by Aizenman et al. (2010) that measure the extent of achievement in each of the three policy goals in the trilemma—monetary independence, exchange rate stability, and financial openness—we examine how policy configurations affect macroeconomic performances, with focus on the Asian economies. We find that the three policy choices matter for output volatility and the medium-term level of inflation. Greater monetary independence is associated with lower output volatility while greater exchange rate stability implies greater output volatility, which can be mitigated if a country holds international reserves (IR) at a level higher than a threshold (about 20% of GDP). Greater monetary autonomy is associated with a higher level of inflation while greater exchange rate stability and greater financial openness could lower the inflation rate. We find that trilemma policy configurations affect output volatility through the investment or trade channel depending on the openness of the economies. Our results indicate that policy makers in a more open economy would prefer pursuing greater exchange rate stability while holding a massive amount of IR. Asian emerging market economies are found to be equipped with macroeconomic policy configurations that help the economies to dampen the volatility of the real exchange rate. These economies' sizeable amount of IR holding appears to enhance the stabilizing effect of the trilemma

* Corresponding author.
E-mail address: mchinn@lafollette.wisc.edu (M.D. Chinn).

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policy choices, and this may help explain the recent phenomenal buildup of IR in the region. *J. Japanese Int. Economies* **25** (3) (2011) 290–320. Department of Economics, University of California, Santa Cruz, United States; National Bureau of Economic Research, United States; School of Public Affairs and Department of Economics, University of Wisconsin, United States; Department of Economics, Portland State University, United States.

1. Introduction

In the fall of 2008, many countries worldwide got hit by the most severe and persistent crisis since the Great Depression. While advanced economies continued to be in a frail situation in the aftermath of the crisis – the debt crisis in Europe breaking out in 2010, and the US economy, the epicenter of the crisis, and Japan experiencing a sluggish recovery, bigger emerging economies either hardly got their economies scratched by the crisis or made an incredible, quick comeback. Especially, the emerging markets in Asia were resilient to the crisis; after experiencing a sharp drop in their production and exports, emerging Asian economies' gross domestic product (GDP) grew at an average annualized rate of over 10% in the second quarter of 2009 while the US fell by 1%. Emerging East Asia did experience a "V-shaped recovery."

If it comes to pass, the V-shaped recovery in Asia is not unprecedented. In fact, that is how many economies in the region behaved in the aftermath of the Asian crisis of 1997–1998. Despite a severe output contraction in 1998, Asian crisis economies exhibited a remarkable comeback with robust growth in exports and output as early as in 1999. Asia's sharp bounce-back this time is not only impressive but also surprising given that, unlike in the aftermath of the Asian crisis, the US economy did not provide the "demand of last resort" (Aizenman and Jinjarak, 2009) that can fill the foregone demand in the world economy.

The Asian economies' resilience to external shocks in this highly globalized world could suggest one hypothesis that economies in the Asian region, most of which are quite open to international trade in goods and financial assets, are better prepared to cope with economic crises in a highly globalized environment. Fig. 1 shows that output volatility—measured by the standard deviations of per capita output growth rates—for Asian emerging market economies has been maintained at low levels comparable to those of the industrialized economies. One interesting conjecture is that these countries have adopted international economic policies that have afforded them better macroeconomic performance. This suggests that these economies may have adopted international economic policies that allow them to experience better macroeconomic performance. In this paper, we investigate whether Asian economies are better-suited to cope with globalization by examining their economic performance in the context of international economic policies.

In its effort to examine policy configurations, this paper focuses on a central hypothesis in international finance, namely the "impossible trinity," or the "trilemma." The hypothesis states that a country may simultaneously choose any two, but not all, of the following three goals: monetary independence, exchange rate stability, and financial integration. This concept, if valid, is supposed to constrain policy makers by forcing them to choose only two out of the three policy choices. Given that Asian emerging market economies have collectively outperformed other developing economies in terms of output growth stability, it is possible that their international macro-policy management, determined within the constraint of the trilemma, has contributed to making these economies better prepared for higher vulnerability possibly exacerbated by recent globalization.

Using the "trilemma indexes" that measure the extent of achievement in each of the three policy goals [developed by Aizenman et al. (2008)], this paper will examine how policy configurations based on the trilemma affect macroeconomic performances such as output growth, output volatility, inflation volatility, and the medium rate of inflation for developing countries.

Furthermore, this study focuses on output volatility and attempts to identify the channels by which the trilemma policy choices affect output volatility. We examine the volatilities of investment and the