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The Trilemma of International Finance

By N. GREGORY MANKIW

AS the world economy struggles to recover from its various ailments, the international financial order is coming under increased scrutiny. Currencies and exchange rates, in particular, are getting a hard look.

Various pundits and politicians, including President Obama himself, have complained that the Chinese renminbi is undervalued and impeding a global recovery. The problems in Greece have caused many people to wonder whether the euro is a failed experiment and whether Europe's nations would have been better off maintaining their own currencies.

In thinking about these issues, the place to start is what economists call the fundamental trilemma of international finance. Yes, trilemma really is a word. It has been a term of art for logicians since the 17th century, according to the Oxford English Dictionary, and it describes a situation in which someone faces a choice among three options, each of which comes with some inevitable problems.

What is the trilemma in international finance? It stems from the fact that, in most nations, economic policy makers would like to achieve these three goals:

• *Make the country's economy open to international flows of capital.* Capital mobility lets a nation's citizens diversify their holdings by investing abroad. It also encourages foreign investors to bring their resources and expertise into the country.

• *Use monetary policy as a tool to help stabilize the economy*. The central bank can then increase the money supply and reduce interest rates when the economy is depressed, and reduce money growth and raise interest rates when it is overheated.

• *Maintain stability in the currency exchange rate.* A volatile exchange rate, at times driven by speculation, can be a source of broader economic volatility. Moreover, a stable rate makes it easier for households and businesses to engage in the world economy and plan for the future.

But here’s the rub: You can’t get all three. If you pick two of these goals, the inexorable logic of economics forces you to forgo the third.

In the United States, we have picked the first two. Any American can easily invest abroad, simply by sending cash to an international mutual fund, and foreigners are free to buy stocks and bonds on domestic exchanges. Moreover, the Federal Reserve sets monetary policy to try to maintain full employment and price stability. But a result of this decision is volatility in the value of the dollar in foreign exchange markets.

By contrast, China has chosen a different response to the trilemma. Its central bank conducts monetary policy and maintains tight control over the exchange value of its currency. But to accomplish these two goals, it has to restrict the international flow of capital, including the ability of Chinese citizens to move their wealth abroad. Without such restrictions, money would flow into and out of the country, forcing the domestic interest rate to match those set by foreign central banks.

Most of Europe’s nations have chosen the third way. By using the euro to replace the French franc, the German mark, the Italian lira, the Greek drachma and other currencies, these countries have eliminated all exchange-rate movements within their zone. In addition, capital is free to move among nations. Yet the cost of making these choices has been to give up the possibility of national monetary policy.

The European Central Bank sets interest rates for Europe as a whole. But if the situation in one country — Greece, for example — differs from that in the rest of Europe, that country no longer has its own monetary policy to address national problems.

Is there a best way to deal with this trilemma? Perhaps not surprisingly, many American economists argue for the American system of floating exchange rates determined by market forces. This preference underlies much of the criticism of China’s financial policy. It also led to skepticism when Europe started down the path toward a common currency in the early 1990s. Today, those euro skeptics feel vindicated by the problems in Greece.

But economists should be cautious when recommending exchange-rate policy, because it is far from obvious what is best. In fact, Americans’ embrace of floating exchange rates is relatively recent. From World War II to the early 1970s, the United States participated in the Bretton Woods system, which fixed exchange rates among the major currencies. Moreover, in 1998, as much of Asia was engulfed in a financial crisis, Robert E. Rubin, then the Treasury secretary, praised China's exchange-rate policy as an "island of stability" in a turbulent world.

Even the euro experiment is based in part on an American model. Anyone taking a trip across the United States doesn't need to change money with every crossing of a state border. A common currency among the 50 states has served Americans well. Europeans were aspiring for similar benefits.

To be sure, Europe is different from the United States, which has a large central government that can redistribute resources among regions as needed. More important, our common language and heritage allow labor to move freely among regions in a way that will always be harder in Europe. The United States of Europe may have been too much to hope for.

Without doubt, the world financial system presents policy makers with difficult tradeoffs. Americans shouldn't be too harsh when other nations facing the trilemma reach conclusions different from ours. In this area of economic policy, as well as many others, there is room for reasonable nations to disagree.