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The trilemma policies and macroeconomic volatility in Central and Eastern Europe

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Abstract

In this paper we search for evidence on the consequences of the trilemma policies on the volatility of macroeconomic variables in selected CEE countries, members of European Union. This problem gained a significant importance during recent financial crisis, when countries in this part of the world were confronted with uncertainty regarding their macroeconomic evolution. We use the trilemma indexes built by Aizenman, Chinn and Ito (2011) to test the consequences of the policies on the inflation and output volatility. Our results show that capital mobility has a positive impact on reducing the macroeconomic volatility in Central and Eastern Europe.

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Keywords: trilemma policies; macroeconomic volatility; Central and Eastern Europe

1. Introduction

In the last years, due to the consequences of the current financial crises, there are many concerns in finding the fitted economic policy mix for achieving the optimal macroeconomic evolution, especially in European Union economies. One issue that occurs is the "impossible trinity" or "open economy trilemma", which means the impossibility of adopting fixed exchange rates, domestic monetary autonomy and open capital markets all at once. As empirical literature demonstrates, only two of these three policies can be used in the same time.

Another issue is the trilemma policies' consequence on inflation, economic growth, interest rates and other macroeconomic variables. The European Union is based on the idea of the benefits that could arise through currency risk elimination and the high degree of openness of an economy. The economic wisdom suggests that

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these factors lead to an increase of economic growth and to inflation rate stability. In this context, EU's economies that follow the objective of adopting euro currency should be preoccupied about policies that have an optimal economic impact.

In this paper we search for evidence of the trilemma policies' consequence on the volatility of macroeconomic variables in selected non-euro new members of European Union, using the trilemma indexes built by Aizenman, Chinn and Ito (2011). To our knowledge, there are no other studies that examined the impact of trilemma on the volatility of inflation rate and economic growth for the period and on the sample of EU countries specified.

2. Literature review

There are many empirical regional and single country studies that deal with the "impossible trinity of international economics". Many of them confirm the "trilemma" hypotheses (Borensztein et al. (2001), Shambaugh (2004), Obstfeld et. al (2005), Miniane and Rogers (2007), Bluedorn and Bowdler (2010), Hsing (2012a, b), Căpraru and Ihnatov (2011 a, b; 2012)), but some of them demonstrate the contrary or show no evidence of "impossible trinity" hypotheses (Frankel (1998, 2004), Calvo and Reinhart (2000, 2002), Bordo and Flandreau (2003), Flood and Rose (1995), Rose (1996), Hausmann et al. (1999), Fratzscher (2002))

Aizenman, Chinn and Ito (2008) assess the trilemma during the post Bretton-Woods period. They find different results for groups of countries. After the early 1990s, industrialized countries increased financial openness, while reducing the extent of monetary independence and increasing exchange rate stability (as a consequence of the introduction of the euro). On the other hand, the emerging market countries pursued exchange rate stability up to the late 1980s, while non-emerging market developing countries have pursued it continuously since 1970. In another paper, the same authors show that the three policy choices have implications for output volatility and the medium-term level of inflation (Aizenman, Chinn, and Ito, 2011). Their results demonstrate that greater monetary independence is associated with lower output volatility and greater exchange rate stability determines greater output volatility. Greater monetary autonomy is also associated with a higher level of inflation, but greater exchange rate stability and greater financial openness could have lowering effects on the inflation rate. Aizenman and Ito (2012) find that in the last two decades emerging market economies with more converged policy choices have smaller output volatility and those with relatively low international reserves to GDP ratios could encounter higher levels of output volatility when they follow a policy combination with a greater degree of policy divergence. Their results also show that economies with relatively high international reserves to GDP ratios do not experience increased output volatility.

Hsing (2012a) finds for Bulgaria that more exchange rate stability has increasing effect on the growth rate of real GDP, whereas more monetary independence or free capital mobility reduces the growth rate. He also demonstrates that inflation rate, inflation volatility and output volatility are not affected by either one of the three trilemma policies. In another paper, Hsing (2012b) finds support for the trilemma for the Czech Republic, the results suggesting that more exchange rate stability raises the GDP growth rate; more monetary independence raises the inflation rate, inflation volatility and output volatility and reduces the growth rate and more financial integration raises the inflation rate and inflation volatility. Ihnatov and Căpraru (2012) find that the floating and intermediate regimes have superior effect on economic growth comparing to the fixed arrangements for 16 Central and Eastern European countries. In the case of country samples assessed the exchange rate arrangement choice is very important in the years before Euro adoption. Paun and Topan (2013) analyze the relationship between broad money dynamics and CPI, in order to illustrate the monetary causes of inflation in Romania.