The Economist

Buttonwood

Three’s a crowd

The instability that stems from trilemmas

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THERE is always resistance when new words are coined, or become modish; the offending term is attacked for being ugly, superfluous or obfuscating. But sometimes a word illustrates a useful concept. So it is with trilemma. If a dilemma represents a choice between two (often unpalatable) options, a trilemma involves the inevitable sacrifice of one of three desirable characteristics.

Perhaps the best known economic trilemma is that to which monetary regimes are subject. A country can have a fixed exchange rate, free movement of capital or independent monetary policy, but not all three. Under the gold standard capital flowed freely and exchange rates were fixed, but monetary policy had to adjust to maintain the peg to gold. Bretton Woods had fixed rates and independent monetary policy, but that required capital controls.

The designers of Bretton Woods were in favour of fixed currencies because they prevent competitive devaluations and give greater certainty to international investors and those involved in trade. But when the system collapsed in the 1970s, most economists inclined to the view that floating currencies were preferable because they give economies more flexibility. Nevertheless large parts of the world still feel differently: China manages its exchange rate against the dollar and Europe went to the trouble of establishing a single currency in part to bring an end to the gyrating exchange rates among the countries that now use the euro.

Dani Rodrik of the Institute for Advanced Study came up with another trilemma in his book “The Globalization Paradox”. Countries cannot simultaneously pursue democracy, national self-determination and economic globalisation. One could combine democracy and globalisation if people were willing to give up the nation state. But accepting globalisation means that some rules will be set internationally, limiting voters’ freedom to pursue certain policies, such as protecting infant industries or workers’ rights. Mr Rodrik thinks that the wishes of voters should override the demands of globalisation.

Another topical trilemma concerns regulation of the financial system. As Dutch academic Dirk Schoenmaker has pointed out, it is impossible to combine financial stability, internationalised finance and national sovereignty. Since big banks operate across national boundaries, one needs a global regime (such as the Basel rules on capital) to monitor them. If national governments are allowed too much flexibility in creating their own rules, instability is the likely result.

Once one starts thinking about trilemmas, they can be found everywhere. Health systems have to choose among the “three Cs”—cost, coverage and choice. A country can have universal health coverage, as in the British system, but at the expense of choice. Or it can have lots of patient choice, as in America, but only by limiting coverage or allowing costs to escalate (or both).

These trilemmas illustrate a couple of important points. The first is that in a social science like economics there are very few “right” answers. All policy decisions involve trade-offs. Different generations of politicians (and voters) will favour different solutions. Certainty about exchange rates is less valued (in Britain and America, at least) than it was a hundred years ago; the economic benefits of globalisation have prompted many countries to place less emphasis on national sovereignty than they used to.

As a profession, economics is as prone to fads as any other. Take inflation, where over the past 50 years, policymakers have lurched from statutory controls on prices and wages through monetarism to inflation targeting. Each policy has had its pros and cons: for example, the low level of inflation in the early 2000s seems to have made central bankers too complacent about the excesses building up in the finance sector. The banking crisis was the result.

By the same token, almost any policy change is bound to cause dissatisfaction among some groups. Sudden moves in exchange rates lead to attacks on market speculators or complaints about competitive devaluations and talk of “currency wars”. Adopting globalisation-friendly policies causes resentment among businesses and workers who lose out to international competition, but adopting a siege economy approach causes such damage that, in the long run, nearly all voters become disenchanted. In the circumstances, sudden lurches in economic policy are only to be expected. Trilemmas breed instability.

Correction: In a earlier version of this article we said that Dani Rodrik was affiliated with Harvard University. He was, but is now at the Institute for Advanced Study. This was corrected on July 4th 2014. Sorry.

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