Globalisation, inflation and monetary policy Banque de France's international symposium

Olivier De Bandt, Laure Frey
Macroeconomic Analysis and Forecasting Directorate

Olivier Loisel
Research Directorate
Monetary Policy Analysis and Research

The Banque de France organised its fifth biennial international symposium on 7 March 2008 in Paris on "Globalisation, inflation and monetary policy". This highly topical issue attracted more than 250 participants from very diverse circles: almost sixty central banks were represented; ten representatives of international institutions, almost thirty prominent academics and twenty high-ranking managers of private banks from all regions of the world were also in the audience.

In his opening speech, Christian Noyer emphasised that, contrary to what has been said on several previous occasions, monetary policy is currently very "challenging" from both the operational and the conceptual points of view and hence not at all "boring". Throughout the day, participants exchanged views on the three main topics of interest that emerged: Has globalisation created a favourable background for monetary policy? What role should be assumed by central banks in the current financial crisis? To what extent have these developments changed the tasks of central banks?

Keywords: globalisation, inflation, monetary policy, subprime.
JEL codes: E31, E32, E52, F15, F16, G3

NB: The French language version of this article was published in February 2008 in the Bulletin de la Banque de France *n° 170 (available on the Banque de France website:* http//www.banque-france.fr/fr/publications/bulletin.htm).

1| Have central bankers been lucky or skilled?

The "great moderation", characterized by reduced macroeconomic volatility and low inflation, has been a predominant feature of the last two decades. Participants in the symposium wondered about the role played by monetary policy in these developments. John Lipsky's short answer to the specific question of whether central bankers have been lucky or skilled, a witty "yes", was fairly representative of the participants' views.

1|1 Globalisation seems to have created a favourable background for monetary policy

Globalisation may have helped monetary policy through several channels.

First, with the integration of hundreds of millions of workers from emerging countries in the world market economy, globalisation has amounted to a succession of positive supply shocks and has probably contributed to the boost in productivity, as acknowledged by many participants, including Christian Noyer, Richard Fisher and Yi Gang.

Second, globalisation has reduced the monopoly power of firms and workers by increasing competition in goods and labour markets, as emphasised by Kenneth Rogoff, John Lipsky and Janet Yellen. These developments may have exerted downward pressures on margins and unit labour costs.

Third, as suggested by William White, the savings glut, which has favoured the surge of liquidity, has also reduced global demand ex ante, hence alleviating inflationary pressures.

Fourth, as shown by Kenneth Rogoff's research, globalisation may strengthen monetary policy credibility through its impact on the Phillips curve. Moreover, as suggested by Richard Fisher and Martin Redrado, greater international capital mobility may well have induced central banks to conduct sound monetary policies.

All these developments have contributed to the stylised facts described by William White: inflation has become less persistent, the exchange rate and commodity prices pass-through have decreased, inflation expectations have stabilised at a low level, the Phillips curve has flattened and global supply has gained importance in determining inflation.

In conclusion, globalisation may have provided a valuable implicit support to central banks. As suggested by Kenneth Rogoff, strong productivity growth may even have masked some weaknesses of the monetary policy framework.

1|2 However, this favourable background should not be over-emphasised

Many speakers, including Christian Noyer, Richard Fisher, Martin Redrado and John Lipsky, reminded the participants that in order to have a direct impact on inflation, globalisation should affect the general price level and not only relative prices. Moreover, there is no or limited evidence of variations in the general price level due to globalisation. The direct impact of globalisation on inflation has been estimated to be around a quarter of a percentage point per year by the IMF.

The indirect impact of globalisation on inflation occurs principally through competition on goods, services and labour markets, while its direct impact mainly consists in the price of imports. Janet Yellen made it clear that the empirical evidence on the indirect impact is subject to ample controversy and that this effect may thus be limited.

Philippe Martin also argued that globalisation may not have lowered the sacrifice ratio, which measures the short run trade-off between inflation and activity, and may have even participated in its increase.

Finally, Janet Yellen and Martin Redrado insisted on the pre-eminent role of monetary policy in the decrease and subsequent stabilisation of inflation. Credible monetary policies should be viewed as the primary contributors to the "great moderation".

1|3 Furthermore, this background has become less favourable

"Some say the world will end in fire, some say in ice". Kenneth Rogoff quoted Robert Frost to illustrate the diversity of opinions regarding the main current threats to the global economy. In his metaphor, the "ice" represents the increasing inflationary pressures worldwide, while the "fire" refers to the financial turmoil initiated by the subprime crisis.

First, as stressed by Jean-Claude Trichet, Richard Fisher and John Lipsky, commodity prices, including energy, are historically high, mainly due to the incapacity of supply to adjust upwards to meet demand. The current decoupling of emerging countries from the United States' cycle is contributing to the persistence of high commodity prices.

Second, the global capacities utilisation outlook is becoming less favourable: William White and Janet Yellen pointed out that global slack is decreasing; Kenneth Rogoff and Martin Redrado emphasised the subsequent upward pressures on costs and prices in Asia; Yi Gang cited the ongoing medium run process of convergence in emerging countries.

Third, as explained by Philippe Martin, the future impact of emerging countries' trade on industrial countries' terms of trade depends on the nature of trade growth: if trade growth is mainly due to an increase in emerging countries' productivity, which corresponds to the "intensive" margin, the industrial countries' terms of trade are improving. However, if emerging countries are essentially exporting new products, which corresponds to the "extensive" margin, the industrial countries' terms of trade may deteriorate.

As hinted by Kenneth Rogoff, Yi Gang and Martin Wolf, the accommodative monetary policy stance during the past years may have contributed to the current pressures. Janet Yellen put forward counter-arguments to that view, maintaining that in terms of real equilibrium interest rates, monetary policy had not been particularly accommodative.

William White mentioned a potential opposite risk of deflation, which would stem from a disorderly resolution of global imbalances.

Recent, more challenging circumstances will serve to stress test the new monetary policy frameworks. As emphasised by John Lipsky, Christian Noyer, Martin Redrado and Richard Fisher, among others, central banks will have to deal with the macroeconomic consequences of financial instability. Meanwhile, they cannot just rely on forecasts pointing to a decline in inflation through the year, since commodity prices are difficult to predict and second round effects may appear.

2| How should central banks interpret and react to the current financial crisis?

While in his introduction Christian Noyer had stressed the urgent necessity to understand the relationships between monetary and financial stability in a more volatile financial environment, the new situation created by the recent crisis was also portrayed by Kenneth Rogoff as a transition for the US economy. Indeed, the United States is now threatened by the "fire" of the financial turmoil initiated by the subprime crisis – additionally to the "ice" of the upsurge in inflation, as mentioned previously.

Three issues were considered by the participants: the origin of the current financial crisis, its main characteristics and the response of central banks.

2|1 The origin of the crisis

Regarding the origin of the crisis, several factors were mentioned. Among them, international capital flows into countries were seen not only as a major factor in small open economies by Alan Bollard, but also as a major and recurrent feature of crisis events by Kenneth Rogoff and Martin Wolf.

A crisis-prone environment was fostered by a situation of abundant liquidity, against a background of excess savings (the "savings glut" hypothesis) and accommodative US monetary policy, according to Kenneth Rogoff and Martin Wolf.

But Hélène Rey and Nout Wellink also mentioned structural institutional weaknesses as the failure of the "originate and distribute" model of financial intermediation which led to moral hazard and the overexpansion of credit.

2|2 Main characteristics of the crisis

The participants also attempted to describe the unfolding of the crisis and its main characteristics, indicating that some were new, but others were more traditional. The crisis indeed contains several new features in the sense that it affects mature markets, notably the US and the UK, several markets at the same time, and that it may even extend further. According to Martin Wolf, "the losses keep bleeding out". But some features appear to be more traditional, as indicated by Kenneth Rogoff on the basis of recent research showing that banking crises often follow the bursting of a house-price bubble.

In addition, a wide consensus emerged on the role of "uncertainty" (in the "Knightian" sense, where the probability distribution is unknown, as opposed to "risk", which banks are used to managing). As shown by Arvind Krishnamurthy, this may arise from the complexity of financial instruments in a period of intense financial innovation. Uncertainty affects behaviours and the functioning of financial systems.

The lack of robustness of some instruments to crisis events and liquidity shortfalls (as evidenced by the Northern Rock case) may also increase uncertainty, leading to the "globalisation of doubts", as coined by Hélène Rey. But this situation was also largely aggravated by amplification effects due to "nonlinearities" and "vicious circles", as also described by Hélène Rey. Pointing to the responsibility of accounting rules (mark to market), she quoted Claude Bébéar who had said that "it is not because your neighbour sells his house at a distressed price that your house is worth a distressed price if you don't need to sell it!"

2|3 Response of central banks

On the one hand, central bankers acknowledged the gains from financial globalisation. In particular for emerging countries, Governor Reddy stressed clear benefits on the equity side, as well as from the gradual liberalisation of the capital account. On the other hand, participants emphasised that the current crisis created new challenges.

For Arvind Krishnamurthy, in a situation where uncertainty is prevalent, central bank policy may take the form of a pre-commitment to a Lender of Last Resort intervention, in order to offer more certainty to market participants. But Nout Wellink warned of the risks of moral hazard created by such a policy. Actions should be co-ordinated among central banks for liquidity provision. In addition, both Arvind Krishnamurthy and Nout Wellink advised central banks and supervisors to concentrate their attention on "pressure points" in risk and liquidity management, in order to prevent the triggering of future crises and the aforementioned "nonlinearities".

Regarding regulatory changes, Martin Wolf expressed his concern that there might be a risk of overregulation. Christian Noyer mentioned that the IMF might have a role to play in order to foster the convergence of financial systems, currently organised or regulated on the basis of very different principles.

Finally, Jacob Frenkel, regarding the marking to market practice as the main ingredient impeding the restoration of liquidity, urged the regulators to communicate to the market the notion that the current markdown is imprecise and is wrong and that there are considerations to deal with that matter.

3| What are the implications of globalisation for the conduct of monetary policy?

The third main issue addressed during the Symposium concerned the possible implications of globalisation for the conduct of monetary policy.

3|1 Monetary policy-making has been complicated by globalisation

There was a general agreement on the fact that globalisation has made monetary policy-making more challenging, for four main reasons.

First, globalisation has made the interpretation of some key stylised facts (lower exchange-rate pass-through in some countries, flattened Phillips curve, and lower inflation) more difficult, as each of them may be due either to globalisation or to the higher credibility of monetary policies. This difficulty in interpreting those facts does matter because their implications for the conduct of monetary policy crucially depend on the interpretation considered, as pointed out by John Taylor.

Second, globalisation has made domestic economies more sensitive to foreign shocks, so that central banks need to commit resources to analyse and closely monitor foreign developments, as acknowledged by Richard Fisher, Donald Kohn and Jürgen Stark. It is for instance very important for the conduct of monetary policy, as stressed by Donald Kohn, to assess whether the recent increase in oil prices will be permanent or transitory.

Third, globalisation has affected the economies structurally and therefore has changed the mechanism of propagation of shocks, as noted by Jürgen Stark.

Fourth, globalisation has affected the monetary policy transmission mechanisms and made them more uncertain, as stressed by Donald Kohn, Christian Noyer and Jürgen Stark, in particular by making the determination of domestic asset prices more dependent on conditions in financial markets worldwide and by strengthening the role of the exchange rate in the monetary policy transmission mechanism. However, as pointed out by Jürgen Stark and Richard Fisher, central banks retain the ability to control short-term interest rates and inflation.

3|2 However, in the view of most participants, globalisation should not fundamentally change monetary policy strategies

At first sight, one could think of many possible ways in which globalisation may call for a change in monetary policy strategies, as stressed by Guillermo Ortiz: for instance, globalisation might call for a reassessment of central banks' price-stability objectives, their economic and monetary analyses or their degree of reaction to diverse variables that become more important in global markets, such as the exchange rate.

However, all things considered, the general consensus was that globalisation should not fundamentally change monetary policy strategies for the following four main reasons.

First, globalisation does not change the rules of monetary economics: as stressed by Jürgen Stark, inflation is still a monetary phenomenon over the medium to longer term and flexible exchange rates remain a *sine qua non* condition for price stability.

Second, and more precisely, globalisation does not call for a monetary policy reaction to exchange-rate developments beyond their effect on domestic inflation, as argued by John Taylor, with whom Eric Chaney and Jürgen Stark agreed. That said, John Taylor suggested, on the basis of the results of a simple econometric analysis, that some central banks (including the ECB) might have recently reacted to exchange-rate developments *per se* – which he regretted. Eric Chaney and Jürgen Stark disagreed on that point (the latter partly on the basis of "inside knowledge") and pointed to alternative interpretations of his results.

Third, especially in an environment of ongoing globalisation, monetary policy must aim at robustly anchoring inflation expectations, as argued by Jürgen Stark. Many other participants, including Richard Fisher, Martin Redrado, Kenneth Rogoff and Janet Yellen, stressed in different ways that the credibility of the determination of central banks to achieve their price-stability objective remain key in the success of their monetary policies.

Fourth, globalisation does not call for further international monetary policy co-operation beyond the co-ordination in the provision of liquidity and an open exchange of views and information, as argued most notably by John Taylor, with whom Donald Kohn and Jürgen Stark strongly agreed.

For all these reasons, Christian Noyer and Jürgen Stark stressed that, in particular, the ECB monetary policy strategy, with its clear mandate for price stability, its definition of price stability in terms of total inflation (as opposed to underlying inflation) and its two-pillar framework, was well-equipped to cope with the challenges that globalisation brings for monetary policy.

This general consensus notwithstanding, there were essentially two main points raised by individual participants in favour of a change in monetary policy strategies in the face of globalisation.

First, Eric Chaney used a price stickiness asymmetry argument to suggest that the price stability objective of central banks be lowered during periods when the net effects of globalisation are disinflationary and, conversely, raised when these net effects turn inflationary.

Second, Martin Wolf argued that one lesson of the current financial turmoil (itself perhaps partly due to financial globalisation) is that monetary policy should consider reacting to the perceived development of asset-price bubbles, even if this may imply pushing inflation temporarily below target.