# Commentary: Impact of Globalization on Monetary Policy

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Like Gaul, Ken Rogoff's paper is divided into three parts: the impact of globalization on the inflationary process; the persistence of volatility in asset prices despite greater macroeconomic stability; and the consequences of increased openness for the conduct of monetary policy. I shall say a few words on each.

If you ask the average businessperson why inflation has been low during the past decade, he or she is almost certain to reply that it is down to cheap imports from the Far East and Eastern Europe. Monetary policy probably won't get a look in, yet we know that inflation must ultimately be a monetary phenomenon. The answer, of course, is that globalization represents a shock to relative, not absolute, prices. What happens to the general price level depends on what monetary policy makers decide to do. But there is, as Ken notes, a grain of truth in the popular view, in so far as the beneficial terms of trade shock have temporarily lowered the natural rate of unemployment and provided a favorable "tailwind" to central banks' attempts to hold inflation down.

But winds can be changeable, and Ken observes that the process may go into reverse at some point. To an extent, this may already be happening. While the Sino-Indian development miracle probably has

some way to run, the near-tripling of oil prices over the past couple of years and the rise in commodity prices more generally are surely in large part a reflection of the rapid industrialization of China and the other emerging economies. The fact that the rise in oil prices is the flip side of the globalization shock to me renders suspect the practice of focusing on measures of core inflation that strip out energy prices, while retaining the falling goods prices.

The structural changes in the industrialized economies brought about by globalization seem rather more fundamental. At this conference three years ago, Ken argued that these changes had increased the incentive to stabilize inflation at a low level. I have no problem with his argument that increased competitive pressures reduce the wedge between the natural and efficient levels of output, and that this, together with the greater role played by the exchange rate, lowers the incentive to inflate. (Though this argument seems less relevant for nations with independent inflation-targeting central banks than for countries where policy is subject to political pressures.)

I am less convinced, however, that globalization will result in a steepening of the short-run output-inflation tradeoff. Extant analyses of the tradeoff in open economies instead suggest that the increased specialization resulting from globalization *reduces* the response of inflation to the domestic output gap and makes it more sensitive to the world output gap, leading to a flatter tradeoff (see Gali and Monacelli, 2005; and Razin and Yuen, 2002).[1] Moreover, increased competition from labor-abundant economies means that businesses have less scope to raise their prices in the face of strong demand. This suggests that we might expect to observe greater countercyclicality in price markups (such an effect is absent by construction in standard New Keynesian analyses). This is exactly what Batini, Jackson, and Nickell (2005) find. And workers have less scope to negotiate higher earnings when faced with potential offshoring and the actual or threatened use of migrant labor, limiting the effect of higher activity on the marginal cost of labor.

Ultimately, the impact of globalization on the short-run output-inflation tradeoff must be an empirical issue, but such a flattening has indeed been observed in a number of industrialized countries in recent years, and appears to be related to increased openness as well as the decline in inflation (Daniels, Nourzad, and Vanhoose, 2005). Some recent empirical studies also find a heightened role for global output gaps in national pricing relationships (see, for example, Borio and Filardo, 2006).

On the face of it, this flattening of the output-inflation tradeoff appears to be both good and bad news for policymakers. The good news is that demand shocks and policy errors will not show up in large deviations of inflation from target, if one starts from there. The bad news is that if inflation starts above target, then it appears to be more costly to get it down. When coupled with the fact that increased capital market integration potentially reduces the central bank's leverage over domestic real interest rates, it, therefore, might appear that monetary policy is losing traction as far as the control of domestic inflation goes.

That would be going too far. Although the transmission channel via domestic demand might be weaker, monetary policy would still impact the price level through the nominal exchange rate and inflation expectations. But the link from interest rates to exchange rates does not seem to be a very tight one, and we still understand relatively little about how inflation expectations are formed. So, the impact of policy decisions might become rather less predictable. Certainly maintaining the high degree of inflation stability that we have seen over the past decade may prove difficult.

Globalization also appears to have affected the way economies respond to cost shocks. One reason why the impact of higher oil prices has been relatively benign is that wages and prices have not reacted in the way they did in the 1970s. In part, that may be a result of the counterinflationary credibility of monetary policies. But it also appears that heightened competitive pressures mean that businesses have frequently felt unable to pass on such increases in higher prices

and have instead looked to lower costs, by granting lower wage increases, putting downward pressure on the costs of other inputs, or raising efficiency. Certainly that is what our business contacts in the United Kingdom have been telling us (see pp. 34-36, Bank of England, 2006).

Turning to the second theme in the paper, Ken observes that the well-documented decline in the volatility of output (and inflation) witnessed over the past two decades or so has not been matched by lower volatility in equity prices and exchange rates. While the jury is still out on the relative importance of structural changes, better monetary policy, and plain good luck, it is plausible that at least some of the increased macroeconomic stability is connected to globalization, in particular more complete risk shifting in better integrated financial markets, as well as the aforementioned changes in wage and price behavior.

But why haven't asset prices become more stable, too? Certainly standard theories of equity pricing might lead one to expect such an outcome if profits have become more stable. Ken makes the neat and original point that, as a simple matter of arithmetic, a reduction in the rate used to discount those profits means that a given variance in that discount rate will generate proportionately bigger swings in asset prices. So, lower risk-free rates, and lower risk premia associated with greater stability, might help to explain the absence of any noticeable decline in asset price volatility as normally measured. This sort of argument doesn't appear capable of rationalizing the findings in regard to the exchange rate, though.

In the coda to his paper, Ken suggests that the greatest challenge to monetary policy during the globalization period has been this continuing volatility of asset prices. My take is slightly different. I do not think it is volatility per se that has troubled policymakers—after all, the swings in asset prices appear to have been no greater than in earlier periods. Rather, policymakers have at various times had to judge whether elevated equity prices, bond prices, house prices, or exchange rates are justified by changed fundamentals or instead are likely to correct sharply, jeopardizing both monetary and financial stability.

Finally, Ken tackles the more specific question of how openness should affect the choice of target price index—or, equivalently, what sorts of shocks justify a deviation for a given target price index. There is already substantial theoretical literature on the appropriate choice of target on efficiency grounds, which suggests that it hinges on the location of the nominal rigidities in the economy—the basic principle being to seek to stabilize the prices that are relatively sticky. In the context of an open economy, a lot then depends on how imported goods are treated, with the majority of studies unfortunately ignoring the pricing-to-market and slow pass-through that we observe in the real world.

Although the theoretical debate is not yet closed, Ken suggests that is unwise for policy to react to the exchange rate independently of its effects on future consumer price inflation and output because it is akin to an asset price, but there is a case for the accommodation of terms-of-trade shocks. I believe that a concern that an asset price boom-bust may lead to medium-term instability can still be captured within an inflation-targeting framework if the time horizon is suitably elongated (Bean, 2003). I find Ken's first conclusion entirely reasonable, especially given the apparent noise in exchange rate movements to which he draws attention.

Most central bankers—even inflation targeters—also will recognize his conclusion that terms-of-trade shocks should be accommodated, at least to some degree. However, to me, the most important issue is not whether there is a theoretical case for such accommodation. Rather, it is whether there are likely to be any adverse effects on inflation expectations and credibility from doing so. Even if we explain that our intention is only to accommodate the first-round effect of a major adverse terms-of-trade shock—such as the recent rise in oil prices—and not any second-round effects, can we be sure that households and firms will behave appropriately and that medium-term inflation expectations will remain anchored? At present, that is not something the literature helps us answer. But given the potential costs of restoring credibility once it is lost, it may be better to err on the side of caution.

Overall, the changes wrought by globalization seem to have supported the pursuit of low and stable inflation in the industrialized economies, even if the mechanisms have been more subtle than the popular view of the role of China and the other industrializing countries suggests. But globalization also has created tensions at the microeconomic level in the shape of growing protectionist pressures in the adversely affected sectors and at the macroeconomic level in the form of global current account imbalances. These still have the potential to upset the apple cart. So, let me conclude with a couple of pertinent Chinese proverbs: “There is no everlasting banquet under the sun,” and “Good luck seldom comes in pairs, but troubles never walk alone.” Policymakers may do well to remember them.

## Endnote

[1]In these models, the more complete risk spreading associated with international capital market integration also flattens the output-inflation tradeoff because it attenuates the wealth effect of demand shocks on labor supply. The empirical significance of this channel is debatable, however.

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