BANK OF ENGLAND

Speech

Jackson Hole Symposium

Comments by

Charles Bean, Executive Director and Chief Economist of the Bank of England

26 August 2006

All speeches are available online at www.bankofengland.co.uk/publications/Pages/speeches/default.aspx

Comments on Ken Rogoff: "Impact of Globalization on Monetary Policy"
Jackson Hole, 26/8/06

Like Gaul, Ken's paper is divided into three parts: the impact of globalization on the inflationary process; the connections between globalization and asset price volatility; and the implications of openness for the conduct of monetary policy. I shall say a few words on each.

If you ask the average businessman why inflation has been low over 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 then 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 has temporarily lowered the natural rate of unemployment and provided a favourable 'tailwind' to central banks' attempts to hold inflation down.

But winds can be changeable, and Ken notes 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, is surely itself in large part a reflection of the rapid industrialisation 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 highly suspect the practice of focussing on measures of core inflation that strip out energy prices while retaining the falling goods prices.

The structural changes in the industrialised economies brought about by globalization seem rather more fundamental. Increased competition from labour-abundant economies means that businesses have less scope to raise their prices in the face of strong demand. And workers have less scope to negotiate higher earnings when faced with potential off-shoring and actual or threatened use of migrant labour. As well as raising the natural rate of output, domestic inflation becomes less sensitive to the domestic output gap and potentially more sensitive to the world output gap[1]. Such a flattening of the short-run Phillips curve has indeed been observed in a number of industrialised countries, and appears to be partly related to increased openness[2], though the fact that the flattening began in the late 1980s or early 1990s suggests that the decline in inflation may also be a factor.

---

[1] For a theoretical analysis of the Phillips curve in an open economy, see Razin and Yuen (2002).
[2] See e.g. Daniels, Nourzad and Vanhoose (2005).

Some recent empirical studies also find a heightened role for global output gaps in national Phillips curves[3].

At this conference three years ago, Ken argued that these structural changes would increase the incentive to stabilise inflation at a low level. I don't propose to say anything more on the political economy arguments, other than that they seem less relevant for countries with inflation-targeting central banks like my own, than they do for countries where policy might be more subject to political considerations.

However, I do think it is worth dwelling on the implications of these structural changes in the inflation process for the conduct of monetary policy. On the face of it, the flattening of the Phillips curve appears to be both good news 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.

This would be going too far. Although the channel of transmission via domestic demand might be weaker, monetary policy would still impact on the price level through the nominal exchange rate and through inflation expectations. But the link from interest rates to exchange rates does not seem to 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 very high degree of inflation stability that we have seen over the last 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 counter-inflationary credibility of monetary policies. But it also appears that heightened competitive pressures mean that businesses have frequently felt unable to pass such increases on in higher prices and have instead looked to lower costs, either by granting lower wage increases, or by putting downward

[3] See e.g. Borio and Filardo (2006).

pressure on the costs of other inputs, or by raising efficiency. Certainly that is what our business contacts in the United Kingdom have been telling us[4].

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 behaviour.

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 explain the absence of any noticeable decline in asset price volatility as normally measured. This sort of argument doesn't appear capable of rationalising 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 policy makers – 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, jeopardising 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 now a growing 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 stabilise the prices that are relatively sticky. In an open economy context, a lot then depends on how imported goods are treated, with the majority of studies

[4] See pp.34-6 of Bank of England (2006).

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 believes that is unwise for policy to react to the exchange rate independently of its effects on future consumer price inflation and output, but that there is a case for the accommodation of terms of trade shocks. I have argued elsewhere[5] that concerns that asset price boom-busts may generate medium-term instability can still be adequately captured within a framework of flexible inflation targeting by adopting a suitably elongated time horizon, so I find Ken's conclusion in regard to exchange rates entirely reasonable, especially given the apparent noise in exchange rate movements to which he draws attention.

As to his conclusion that terms-of-trade shocks should be accommodated to some degree, I think that is an argument that most of the central bankers in the audience will recognise, even the inflation targeters. 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 been beneficial to the pursuit of low and stable inflation in the industrialised economies, even if the mechanisms have been a bit more subtle than the popular view of the role of China and the other industrialising countries suggests. But globalization has also 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 the global current account imbalances. These still have the potential to upset the apple cart. So let me conclude with a couple of old Chinese proverbs: "There is no never-ending banquet under the sun" and "Good luck seldom comes in pairs, but bad things never walk alone". Policymakers may do well to remember them.

---

[5] See Bean (2003).

References

Bank of England, 2006, *Inflation Report*, August.

Bean, Charles R., 2003, "Asset Prices, Financial Imbalances and Monetary Policy: Are Inflation Targets Enough?" in *Asset Prices and Monetary Policy*, eds. A.Richards and T. Robinson, Reserve Bank of Australia, Sydney.

Borio, Claudio and Andrew Filardo, 2006, "Globalization and Inflation: New Cross-Country Evidence on the Global Determinants of Domestic Inflation", mimeo, Bank for International Settlements, Basle.

Daniels, Joseph P., Farrokh Nourzad and David D. Vanhoose, 2005, "Openess, Central Bank Independence, and the Sacrifice Ratio", *Journal of Money, Credit and Banking*, Vol. 37(2), April, pp.371-379.

Razin, Assaf and Chi-Wa Yuen, 2002, "The "New Keynesian" Phillips Curve: Closed Economy vs. Open Economy", *Economics Letters*, Vol. 75, May, pp.1-9.