Globalization and Monetary Policy

Additional Information

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Introduction

Central bankers share a common responsibility — keeping the purchasing power of our currencies stable. Over the past 30 years, policymakers around the world have come to realize that a low and stable rate of inflation is indispensable for achieving other objectives, like maximum sustainable economic growth, healthy labor markets, and financial stability.

As a policymaker, I find myself in a challenging environment. In the United States, the headline Consumer Price Index, or CPI, is rising at 4%, and the core CPI, which takes out food and energy prices, is rising at 2.4%. Yet despite price pressures, the Federal Reserve has cut its federal funds rate target by 325 basis points since last fall in response to turmoil in financial markets and to head off the associated downside risks to economic growth. The substantial easing of monetary policy to date, combined with ongoing measures to foster market liquidity, should help to promote growth over time and to mitigate risks to economic activity. I know that some observers are saying that this strategy introduces other risks. For example, some individuals question whether by lowering our policy rate in the face of price pressures, we put at risk our goal of keeping inflation low and stable over the long term.

While even the core price measures in the United States are rising somewhat faster than I would prefer, and inflation presents a key risk to my outlook, I believe that the Federal Reserve's policy strategy remains compatible with a low and stable inflation rate. To better understand this strategy, I think it is important to distinguish between the concept of inflation and the concept of relative-price changes. This distinction is especially critical today, when relative price pressures are both global and intense.

Today, I will explain how global price pressures can increase the complexity of formulating monetary policy. I will begin by describing the traditional definition of inflation. Then, I will discuss the important distinction between inflation and relative price pressures. Finally, I will draw on this distinction to explain why globalization has not curtailed the ability of monetary policymakers to achieve price stability.

Please note that the views I express today are mine alone and do not necessarily reflect the views of my colleagues in the Federal Reserve System.

Inflation

Let me begin by defining a word in the economist's lexicon that is often misused — inflation. Inflation refers to deterioration in the purchasing power of money. It occurs when a central bank creates

more money than the public wants to hold. The result is an eventual rise in all prices and wages. And as long as this disparity between the supply and demand for money persists, prices and wages will keep rising.

Inflation is always a home-grown, monetary phenomenon that is ultimately under the control of a central bank. How quickly inflationary impulses filter through to wages and prices, however, depends on many things—most importantly, on the state of inflation expectations and on the degree of slack in an economy. When the public generally anticipates inflation and when an economy is operating at full capacity, monetary excesses can quickly translate into higher prices and wages.

Globalization can exacerbate the inflation process only if it somehow impairs central bank operations, but this seems unlikely. In fact, some scholars believe that globalization has actuallyimprovedthe behavior of central banks by penalizing those whose currencies lack a stable purchasing power. These scholars contend that global competition and the free flow of financial funds have encouraged governments to establish independent, transparent central banks and to accept more exchange-rate flexibility.

Indeed, world inflation moderated during the 1990s as the global integration of financial markets accelerated. From the early 1970s to the early 1990s, for example, world inflation averaged around 16 percent per year, according to the International Monetary Fund. Since the mid-1990s, world inflation has averaged slightly less than 5 percent. Most of the recent improvement has come from developing and emerging market economies—groups that previously lacked monetary-policy discipline. By the mid-1980s, central banks in key developed countries—notably the United States, England, Japan, and many European countries—regained much of the credibility that they had lost in the 1970s. In these countries, residents benefit both from the direct effects of low and stable inflation, and the indirect effects of having a currency with international-reserve status. From this perspective, I do not believe that globalization prevents a central bank from achieving its inflation objective.

Relative-Price Changes

Of course, prices can change for reasons other than inflation. Individual prices continually adjust to changing supply and demand pressures. Economists refer to these as *relative-price* adjustments, and they are fundamentally different from inflation.

Relative-price changes convey important information about the scarcity of particular goods and services. A rising relative price indicates that demand is outstripping supply (or that supply is falling behind demand), while a falling relative price indicates just the opposite. Although relative-price changes can be quite uncomfortable for consumers, they transmit vital information needed for the efficient allocation of resources throughout any market economy. When the relative price of a particular good rises, consumers tend to conserve on that good and look for substitutes. Producers react to a rising relative price by bringing more of the good to market in hopes of boosting profits.

Inflation, by contrast, contributes no information useful to our consumption, production, and labor choices. If anything, inflation can add noise to the price signals that inform our decisions and may lead people to make unsound economic choices. Even worse, inflation can cause people to shift time and resources away from activities that foster production and long-term economic growth and toward activities that serve only to protect their wealth, rather than to expand it.

Globalization does not impair a central bank's ability to control inflation, but — as recent events demonstrate — it can sometimes magnify relative-price changes by exposing individual countries more intensely to global demand and supply pressures. Some of these affect consumers' pocketbooks directly, as through the prices of imported and exported goods. Others, of course, are less direct. A lot of domestic production uses foreign inputs, so domestic costs can rise and fall with global price shocks. Similarly, foreign competition will affect the pricing strategy of domestic firms and the wage demands of domestic labor organizations. Some of the other beneficial effects of globalization are even harder to see. By fostering specialization and technology transfers, global market integration slowly improves productivity and lowers unit costs, thereby supporting lower inflation.

At times, however, developments in world markets can create obstacles for central banks. Petroleum, agricultural goods, and many other commodities are now experiencing strong upward relative-price pressures. Two factors seem to account for most of this. First, the world has experienced nearly unprecedented economic performance in recent years. Between 2004 and 2007, world output expanded at a 4.8 percent average annual rate. While emerging markets in Asia, notably China and India, appear to have led the way, nearly every nation on earth shared in the expansion. This growth and development, however, has placed greater demands on world resources, leading to sharp increases in relative prices. Since 2002, the price of food imported into the Unites States has increased at an average annual rate nearly 4 percent faster than the CPI, and the price of imported industrial commodities has increased at an average annual rate 15 percent faster than the CPI.

The second factor putting upward pressure on relative commodity prices is the dollar's depreciation. Since early 2002, the dollar has fallen at a 5 percent average annual rate on a broad, trade-weighted basis. A dollar depreciation raises the dollar price of goods that U.S. residents import. It also lowers the foreign-currency price of all dollar-denominated goods, whether they are produced in the United States or abroad. In this way, a dollar depreciation shifts world demand toward all goods denominated in dollars, which then raises the relative dollar price of all such traded goods.

Relative-price pressures can be fairly broad-based. Oil and agricultural products enter the production processes of a wide range of other goods, from plastics to processed foods. Relative-price pressures can also be persistent. Oil prices have ratcheted up over the past nine years and the dollar has depreciated for more than six years. Nevertheless, as long as a central bank is not creating an excessive amount of money, these relative price pressures ought to be transitory. As consumers spend more money for higher-priced petroleum and agricultural goods, they eventually have less money to spend on other goods and services. Other relative prices must then fall. Eventually, the average rate at which prices change will be the inflation rate as determined by the central bank.

Now, clearly, if people spend more on necessities such as higher-priced energy and agricultural goods, their overall cost of living will rise. If they do not also produce and sell these same commodities — as is typically the case — their standards of living will fall, that is, their incomes will buy less. Indeed, we have recently witnessed food riots in some developing countries. While sometimes devastating, these global relative-price pressures are not the same thing as inflation.

Central Banks in a Global Economy

I have drawn a subtle, but important distinction between relative-

price pressures and inflation. Central banks cannot do anything about relative prices. We do not produce oil, wheat, rice, or any other commodities. But through our monetary policy actions, we can create or prevent inflation. Globalization has not fundamentally impaired our ability to provide long-term price stability, but it complicates monetary policy in at least two key ways.

First, global relative price shocks can obscure a policymaker's ability to interpret price statistics, making it harder to distinguish between temporary relative-price changes and inflation trends. We find ourselves needing to analyze such things as the underlying nature of foreign disturbances, or the persistence of exchange-rate changes, or the degree of pass-through to import prices, or the response of domestic competitors. Simply put, globalization requires us to expand the amount of information we consider in our policy-making process. Second, our ability to accurately interpret price statistics affects our ability to communicate effectively with the public. Effective communication helps us anchor inflation expectations. Lapses in our ability to convey accurate and timely information about the underlying nature of price changes can create uncertainties about central bank objectives, damage our credibility, and impose costs on the economy.

But, as I have said throughout my talk today, globalization complicates our task; it does not prevent us from achieving our goals.

Conclusion

I hope that my remarks have further clarified the subtle, but very important, difference between relative-price pressures and inflation. I believe that the difference hinges on a distinction between relative-price changes, which central banks can do nothing about, and inflation, which central banks control.

As I outlined, globalization has increased the complexity of distinguishing between relative-price changes and inflation, but I do not believe that globalization has fundamentally curtailed the ability of central banks to achieve their inflation objectives.