Coping with Globalization's Impact on Monetary Policy

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Many of my fellow Federal Reserve Bank presidents are economists by training and trade. I am not. My academic training culminated in an M.B.A. Before coming to the Dallas Fed, I made my living as an investor in globally diversified equities and distressed debt, and after beating the house for 20 years, I figured I was pressing my luck and cashed in to become a U.S. trade negotiator. I do not mind admitting to some apprehension about speaking to an audience of economists on an economic topic. But I am very comfortable with a subject I consider one of the biggest challenges my colleagues and I must cope with: globalization's impact on the gearing of the economy and the making of monetary policy.

The literature on globalization is large. The literature on monetary policy is vast. But the literature examining the combination of the two is surprisingly small.

A search for scholarly articles with the words "globalization" and "monetary" and "policy" turns up 31,500 references. Narrowing your quest to the exact word combination "globalization and monetary policy" produces only 39 citations. Limiting the word combination to the title of an article, you will find just two articles.

Tom Friedman's popular book *The World Is Flat: A Brief History of the Twenty-First Century* doesn't have a single entry on "money," "monetary policy" or "central banking." The word "globalization" does not appear in the index of Michael Woodford's influential *Interest and Prices: Foundations of a Theory of Monetary Policy*. Nor do the words "international trade" or "international finance."

What gives? Is the process of globalization disconnected from monetary policy? Is central banking totally divorced from globalization?

I think not. I believe globalization and monetary policy are intertwined in a complex narrative that is only beginning to unfold.

Let me tell you of one eye-opening experience. About two years ago, I was in London on business for Kissinger McLarty, where I worked after the U.S. Trade Representative's office and before joining the Fed. I received a call from the head of Japan's equivalent of the Business Roundtable, the Keidanren, asking me to pop over to give a couple of speeches. They made an offer I couldn't refuse, and I said I would be happy to travel to Tokyo if they could schedule the flights. They booked me on Virgin Air and arranged for a car to take me to Heathrow.

At the appointed time, the car didn't show up. So I called the number I had been given, and on the other end was a woman with a frightfully British accent. When I asked, "Could you kindly tell me where my car is, ma'am?" she deftly shifted to a Southwestern American accent and said, "Now don't you worry. It is five minutes away. Ah apologize for the delay. Have a nice flight."

I said, "Well, hold on a minute. You answered this call in a British accent but once I spoke, you shifted to a Texas accent. Who are you? Where are you?"

"Well," she answered, "I am a call center operator in Bangalore."

"Have you ever been to the United States?" I asked.

"Oh, no, sir. But I can tell that you are from Arkansas, Texas or New Mexico."

"And how do you learn to speak like me?"

"Well, sir, for people like you, we watch a television show called *Walker, Texas Ranger.*"

"And what if I were from Boston?"

"Ah, for those people we watch *Cheers.*"

It may seem a small matter that a Japanese firm employed a worker in India to track a car by GPS in London and mimic a voice from Texas. But globalization impacts the conduct of business so much more profoundly. The expansion of our productive capacity, the pricing mechanism of labor and other inputs, the relationship between inventories and sales—all are being changed by the global spread of capitalism.

New Ways of Thinking

There are many convoluted definitions of globalization. Mine is simple: Economic potential is no longer defined or contained by political and geographic boundaries. A globalized world is one where goods, services, money, workers and ideas migrate to wherever they can work together most efficiently, flexibly, securely and profitably.

Where does monetary policy come into play in this world?

One of the first books I read as I prepared for my new job as Dallas Fed president was *A Term at the Fed*, an excellent little tome written by former Federal Reserve Governor Larry Meyer. It gives you a good sense of the lexicon of monetary policy deliberations. The language of Fedspeak is full of sacrosanct terms such as "output gap" and "capacity constraints" and "the natural rate of unemployment," known by its successor acronym, "NAIRU," the non-accelerating inflation rate of unemployment.

All of this jargon reflects the fact that central bankers do not wish to strain the economy's capacity to produce. They want GDP to run at no more than its theoretical limit, for exceeding that limit for long might stoke the fires of inflation. One key capacity factor, for example, is the labor pool. The shibboleth known as the Phillips curve posited that beyond a certain point too much employment would ignite demands for greater pay, with eventual inflationary consequences for the entire economy. The econometric calculations behind the Phillips curve and the panoply of other domestic "capacity constraints" and "output gaps" were based on assumptions of a world that in my opinion exists no more.

Meyer's book is a real eye-opener because it describes in great detail the learning process of the FOMC members as the U.S. economy morphed into the new economic environment of the second half of the 1990s. At the time, economic growth was strong and accelerating. The unemployment rate was low, approaching levels unseen since the 1960s. The prevailing views of the Phillips curve, capacity constraints, output gaps and the NAIRU pointed to rising inflation. That is precisely what the Federal Reserve's models were saying, as was Meyer himself, joined by nearly all the other Fed governors and presidents gathered around the FOMC table. Under the circumstances, they concluded that monetary policy needed to be tightened to head off the inevitable.

They were frustrated by Chairman Greenspan's insistence on postponing rate hikes, yet perplexed that inflation wasn't rising. Indeed, it kept falling.

If the conventional wisdom had prevailed, the Fed would have caused the economy to seriously underperform. According to back-of-the-envelope calculations by economists whom I respect, real GDP would have been lower by several hundred billion dollars. Employment gains would have been reduced by perhaps a million jobs. The costs of not getting these critical calibrations right would have been huge.

How was Greenspan able to get it right when other very smart men and women did not? Well, we now see with 20/20 hindsight what Greenspan instinctively saw early on—the fact that accelerating productivity had begun to alter the traditional relationships among economic variables.

Greenspan understood the data and the modeling techniques of the Fed's research staff and other outstanding economists. But he was also constantly talking—and listening—to business leaders. And what they were telling him jibed with what he knew from years of consulting and sitting on corporate boards: They were simply doing their job of seeking any and all means of earning a return for their shareholders. At the time, they were being enabled by new technologies that enhanced productivity. The Information Age had begun rewriting their operations manuals, creating a schism between the efficacy of prevailing theory and real-world practice.

It is important to listen to our economy's business operators. We have millions of experienced managers and decisionmakers in the private sector. This may be our greatest competitive advantage, the wellspring for the mighty economic machine that produces some $12 trillion in economic output. Our business managers are the nerve endings in Adam Smith's invisible hand, stretching the fingers of capitalism into every corner of comparative advantage worldwide. America's business managers have begun taking advantage of globalization, just as they had previously reaped the gains from inventing new technology and then using it.

Consider labor alone. In the early '90s, the former Soviet Union released millions of hungry workers into the system. China joined the World Trade Organization at the turn of the century, and 750 million workers came into play. And now India, with more than 100 million English-speaking workers among its 1 billion people, has joined the game. What does all this mean to American managers paid to enhance returns to shareholders by growing revenues at the lowest possible costs? Because labor accounts for, on average, about two-thirds of the cost of producing most goods and services, the managers will go where labor is cheapest. They will have a widget made in China or Vietnam, or a software program written in Russia or Estonia, or a center for processing calls or managing a back office set up in India or the Philippines.

The destruction of communism and the creation of vast new sources of inputs and production have upset all the calculations and equations of the very best economics minds. How can economists quantify with precision what the United States can produce with existing labor and capital when we do not know the full extent and elasticity of the global labor pool? Or the totality of the financial and intellectual capital that can be drawn on to produce a nation's GDP? How do we measure the inventory-to-sales ratio in a technologically advanced, hyper-interconnected world where offshore sources are expanding geometrically, if not exponentially?

As long as we are able to hold back the devil of protectionism and keep open international capital markets and remain an open economy, how can we calculate an "output gap" without knowing the present capacity of, say, the Chinese and Indian economies? How can we fashion a Phillips curve without imputing the behavioral patterns of foreign labor pools? How can we formulate regression analyses to capture what competition from all these new sources does to incentivize American management?

The old models simply no longer apply in our globalized, interconnected and expanded economy. This is why I think so many economists have been so baffled by the length and strength of the current expansion and the non-inflationary prosperity we have enjoyed over the past almost two decades.

You could sense something was wrong with the econometric equations if you listened to the troops on the ground, fighting in the trenches of the marketplace. That is what my colleagues and I at the USTR did negotiating market-opening trade rounds with China, Vietnam, Mexico, Brazil and others in the late 1990s. It is what my colleagues and I at Kissinger McLarty did while advising dozens of U.S. companies seeking entry into China, the former Soviet satellites, India and Latin America. It is what my colleagues and I on the FOMC do by making dozens upon dozens of calls every month to CEOs, COOs and CFOs of businesses, large and small. We see managers at work expanding the capacity of our economy, expanding the gap between what their previously limited resources would allow them to produce and what their newly expanded globalized, technologically enhanced reach now allows them to produce.

From this, I conclude that the economics profession needs to rejigger its econometric equations to better inform our understanding of the maximum sustainable levels of U.S. production and growth.

Yes, Globalization Matters

There are, of course, those who will argue, at least from a theoretical perspective, that globalization should not matter much in a world of flexible exchange rates. They contend that a central bank can tailor monetary policy to domestic objectives alone when it is not obliged to defend a specific value for the currency.

This proposition, which goes back to John Maynard Keynes, has been taught in economics classes for 50 years or more. Indeed, it was the basis for much of the theoretical economics I was taught as a Harvard undergraduate 37 years ago. The proposition, however, holds only under assumptions I do not think apply in the world we live in today. The theory, for example, requires that capital be completely mobile, equalizing interest rates around the world, and that domestic prices be free from distortions, regulation, trade barriers and the like.

Capital is indeed more mobile than it was 40 years ago, but not completely so. Economies are still far from free of government meddling that distorts the market's price-setting function. You need look no further than the European Union's agricultural policies. The greater the distortion, the higher the inflation. As excess regulations and barriers are eliminated, the central bank's incentives will change and inflation will fall. Kenneth Rogoff made this argument a couple of years ago to explain how globalization has been largely responsible for the worldwide decline in inflation over the past 10 to 15 years.

As good economists, you might protest that liberalized trade policies, the impact of new economic entrants and the like are one-time shocks, unlikely to produce a sustained decline in inflation. In the real world, though, these changes take time to work themselves through the economy. An analogy is the deregulation of banks and airlines in the late 1970s, both supposedly one-off events. Who would argue that these companies aren't still adjusting to these "one-time shocks"? When I helped negotiate China into the World Trade Organization, a process that was not completed until the start of the Bush "43" administration, I knew my yet-to-be-born grandchildren would be dealing with the tail end of the changes wrought by China's entry into the global marketplace.

Globalization still has a long way to go. It will prompt a long-term sequence of changes in the United States and around the world. Its impact has a half-life of at least a dozen years—if I can borrow a term from nuclear physics, a subject about which I know even less than I know about theoretical economics.

To be sure, not everyone buys into my proposition about how globalization impacts worldwide inflation. Even so, as a practical matter, globalization has important implications for monetary policymakers, flexible exchange rates or no. We actually ponder the depths and resilience of Chinese capacity, for example, when we sit around the table of the FOMC. Our understanding of how the economy operates depends on the behavior of economic actors and forces that are new and different in a world of increasing globalization.

It is a world of intense competition, and that creates incentives to raise productivity as well as the means to do so. In the past decade, the U.S. economy's average annual increase in output per hour has been 2.7 percent, just about equal to the extraordinary quarter-century boom that followed World War II. My business contacts talk and act as if the globalization now under way will bring another decade of hypercompetition. This global hothouse will enable, perhaps even force, businesses to keep productivity growth in the range we have enjoyed since the mid-1990s, hopefully for many years to come. If productivity growth can stay near 3 percent, monetary policy can accommodate relatively faster growth without igniting inflation.

I like to say money is the economy's lifeblood. The Federal Reserve's great responsibility is to maintain the cardiovascular system of American capitalism. The Fed's operations—from processing payments to regulating banks to trading foreign exchange to setting the federal funds rate—keep open the arteries, veins and capillaries of capitalism. A healthy cardiovascular system enables the brain and propels the muscles of production. The quality of the money supply is critical to economic success, as is the quantity.

You cannot have the dynamic progress Tom Friedman describes in his book without the well-functioning, reliable monetary regimes central banks have been sustaining. It is an especially intense responsibility for the Federal Reserve, as the *primus inter pares* central bank, serving the largest economy in the world and circulating the world's most utilized currency. One cannot make monetary policy at the Federal Reserve without being cognizant of the forces of globalization acting upon our economy. Nor can one be oblivious to the need to conduct our policy with an awareness of how our actions impact markets and, therefore, economic potential worldwide.

Keeping inflation in check is a central bank's sacred mission. By spurring productivity and fomenting tectonic economic changes, globalization has acted as a tailwind for the Fed's—and other central banks'—efforts to hold down inflation. I believe the Federal Reserve has been able to contain inflation with faster growth than would have been possible in the absence of globalization. In short, globalization has made the Fed's job easier over the past few years.

Will the tailwinds stay with us?

Left to their own devices, I think they would remain for a significant time, but we have to take into account the political dimension. I have expressed my concern about the implications of our fiscal deficits, vowing never to use my vote on the FOMC to monetize excess spending. I have also warned of the dangers of protectionism, which would undercut globalization's favorable impact on inflation. Deficits and protectionism could lead to interest rates higher than they would otherwise need to be in order to maintain low inflation.

As a Texan, I am mindful of the story about William McChesney Martin, Fed chairman from 1951 to 1970. President Johnson invited him down to his Texas ranch for what turned out to be a one-on-one meeting. The president wanted a more accommodating monetary policy, and Martin, a strong advocate of Fed independence, tried to explain to him the consequences of that course of action. Johnson would have none of it and advanced on Martin, shoving him around the room and shouting, "Boys dying in Vietnam, and Bill Martin doesn't care!" Years later, Martin expressed his regrets about shifting policy to suit the president. "To my everlasting shame," he said, "I finally gave in to him."[1]

Presidents Clinton and Bush have allowed the Fed to operate with a high degree of political independence from the administration. On the whole, Congress has also wisely refrained from interference. Without its independence from political interference, I doubt the Fed could have so successfully set the interest rates that have led to today's favorable economic circumstances. Just as I doubt that, without independence from rigid econometric dicta, monetary policy could have so adroitly harnessed, and in turn lubricated, the forces of globalization.

NOTE

[1] This story was recounted in an April 2, 2004, letter from Richard McCormack to then-Federal Reserve Governor Edward M. Gramlich. McCormack, a senior adviser with the Center for Strategic & International Studies, is a former undersecretary of state for economic affairs.