Globalization and the Latin Perspective (with Reference to *Las Meninas*)

Remarks at the Central Bank of Argentina

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Many of my fellow Federal Reserve Bank presidents are economists by training and trade. I am not. My academic career culminated in an M.B.A. from Stanford, received after undergraduate studies in economics at Harvard and a "vacation" reading Latin American Studies at Oxford.

For many years, I made my living as an investor, running a hedge-fund and portfolio-management business that specialized in globally diversified equities and distressed debt. After beating the house for 20 years, I figured I was pressing my luck, and I cashed in, walked away from the game and became a U.S. trade negotiator. As a deputy trade representative, I spent a great deal of time negotiating bilateral issues with Argentina's government. With substantial input from Martin Redrado, I worked with Argentina on plans for the proposed Área de Libre Comercio de las Américas—the ALCA or, in English, the Free Trade Area of the Americas—an effort that, despite our collective best efforts, never got off the ground.

Now, both Martin and I play different roles—we are central bankers. I am delighted to be with him again. I consider him a friend whose company and intellectual insights I value. I thank you, Martin, for inviting me to speak to this distinguished forum today.

I am told that many of you work in the financial industry, as I did many years ago. I feel comfortable sharing my views with people who are out there in the trenches, experiencing every day globalization's impact on their business opportunities and the gearing of their economies.

I come by my interest in globalization honestly. My father was Australian, my mother a Norwegian born and raised in South Africa. They met in East London (South Africa) and tried to get into the United States in 1939, only to be denied entry. So they had to settle instead in Tijuana, right across the U.S. border in Mexico, and they lived there until they became U.S. citizens in 1947. Almost immediately, my father took a job with a chemical company, which sent him to Shanghai to close down operations as the communist forces were decimating the Nationalist army. My parents returned to the United States shortly before I was born in Los Angeles. Not long afterward, we moved to Mexico City, where I attended primary school and learned the less-than-perfect Spanish I am taking the liberty of inflicting upon you today.

Here is the point of all that personal history: I was "manufactured" in China of components that came from Australia and Norway via South Africa. I was "assembled" in Mexico, and I realized my "value-added" in the United States.

I am a true son of globalization.

Let me remind you of another son of globalization: Sir Edmund James Palmer Norton. Sir Edmund was born on the frontier between Denmark and Germany to English parents. After earning an engineering degree in the U.K., he landed a job building a railroad across the Andes from Argentina to Chile. In the process, he visited Mendoza, where he realized the region's potential for wine production. In 1895, he founded a winery in Perdriel, later importing vines from France.

And so, Argentina's wine industry was born. Norton established one of the country's great legacies. Thanks to that industry, a whole region of the country has prospered, belying the claims of those who say globalization impoverishes people and reduces living standards. The wine industry provides thousands of jobs for workers with all levels of education and skills—from the croppers who pick the grapes by hand, to the agricultural engineers who monitor the soils, to the oenologists who supervise the winemaking process. In addition, there is the indirect economic activity from wine country tourism, as well as business in financing vineyard operations and distributing wine here and overseas.

Today, Argentine wines are highly competitive in the global marketplace. Wine lovers the world over have benefited from the availability of Argentine cabernets and merlots on the shelves beside French, Italian, Chilean and California brands. We U.S. consumers are seeing more and more Argentine wines in our stores, and we do enjoy them. And I should add—*in vino veritas!*—that I personally enjoy them very much. I will refrain from any meddlesome comments about Argentina's trade policies as they affect agricultural exports, with one exception: As a connoisseur of wines—please, never ban Malbec exports!

New Ways of Thinking

Let me get serious now. What do I mean by globalization? There are many convoluted definitions of the term. Mine is simple: In the world we now live in, economic potential is no longer defined or confined by political or 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.

Because of my far-ranging origins, I have been drawn to the idea of globalization as a birthright. My experience at the Fed has, if anything, increased my interest in it. I am convinced that central bankers everywhere need to better understand the forces behind globalization as they pursue monetary policies that lay the foundation for sustainable, non-inflationary growth in employment and output. This afternoon, I want to expand on this. I will do so in my personal capacity and, as always, speak today for neither my colleagues at the Federal Reserve nor the other members of the Federal Open Market Committee.

Most of you probably remember the Tequila Crisis. In early 1995, shock waves from a financial earthquake in another hemisphere traveled silently through the Panama Canal and across the Amazon, then exploded over the Pampas. And it all occurred because of the collapse of the market for short-term Mexican government debt, the infamous *tesobonos*. A small lapse thousands of miles away was enough to trigger a panic that almost brought to its knees the dollar-standard regime that had put an end to decades of chronic high inflation in Argentina.

Given this background, as well as other cases of relatively small economies being buffeted by external developments, it is only natural for central bankers here and elsewhere to approach their monetary policy decisions with an eye on developments elsewhere in the world. Domestic monetary policies can sometimes be less important than the effects of the policies adopted by the United States, Europe, Japan and other large economies.

Maybe that is why Latin American central bankers seem in some ways ahead of the rest of the world in realizing globalization's impact on monetary policy. Most of you already know we can no longer assume economic or financial developments in remote parts of the world—new technologies or suppliers in some cases, financial market disruptions in others—will leave our economies unscathed.

This is second nature to you. So you may find it surprising that in preparing for my job at the Dallas Fed, I discovered that U.S. central bankers have not always had the same level of awareness about globalization's importance for monetary policy.

One of the books I read during my self-imparted training for this job was *A Term at the Fed*, an excellent, first-hand account by former Fed Governor Larry Meyer. The book gives 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 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 speed limit because going too fast for too long might stoke the fires of inflation. One key factor influencing the economy's capacity, for example, is the size of the labor pool. The shibboleth known as the Phillips curve posits that increasing employment beyond a certain level will ignite demands for greater pay, with eventual inflationary consequences for the entire economy.

The econometric calculations behind the Phillips curve, capacity constraints and output gaps were based on assumptions of a world that, in my opinion, no longer exists. It is my understanding that conventional economic concepts are also being challenged in these latitudes. Here in Argentina, the jargon is different. It is replete with such terms as "currency substitution," "fear of floating," "sudden stops" and "flight to quality." They conjure up images of a policymaking process conducted amidst the tectonic forces of globalization.

I am almost certain that was the intention of the superb Latin American theorists who pioneered the use of these terms, among them the great Argentine economist Guillermo Calvo. True, I sometimes find references to the Phillips curve in Latin America's monetary policy discussions, but not with the frequency and emphasis I encounter in the United States.

Perhaps economic adversity explains why Phillips curves, output gaps and other such concepts do not enjoy the same popularity in this region as they do in the U.S. Latin America's inflation was rampant in the 1980s. During that so-called "lost decade," many countries experienced chronic but seemingly benign annual inflation rates of 15 percent—if you can call a doubling of the price level in five years benign. Then, almost overnight, inflations turned into hyperinflations. My conjecture is that the dramatic social consequences of those episodes gave policymakers and economists much stronger incentives to understand why their economies did not realize the employment gains the Phillips curve suggests should come with higher inflation.

In the search for answers, Latin American central bankers may have been persuaded early on by the powerful arguments Robert Lucas offered in a 1972 paper that would earn him the Nobel Prize a little over two decades later. According to Lucas, central bankers could not exploit the Philips curve's inflation–output trade-off simply because such a relationship was intrinsically nonexploitable. The negative correlation between the inflation and unemployment rates captured in the Philips curve is a mirage. It is there, you can see it in the data, but you cannot "touch it," so to speak. Attempts to "touch it" will result in stinging frustration: A higher inflation will produce just that, a higher inflation, without any effects on economic activity or employment.

Perhaps globalization had a role in pushing Latin American central bankers to accept Lucas' critique. Every time they had tried to take advantage of the Phillips curve, pushing inflation a little higher to pump up output, the resulting capital outflows sent their economies into recession, reduced tax revenues and forced them to pay the bills by printing money. Making monetary policy decisions with the elusive Philips curve in mind had led to pushing the wrong buttons. Once Latin America's central bankers ceased to trust the Philips curve, inflation rates plummeted. Argentina, for example, could point with pride to one of the world's lowest inflation rates by the 1990s.

Even in the latter part of the '90s, the lessons Latin America's central bankers had learned the hard way had not penetrated the United States. As a result, we almost ended up pushing the wrong buttons. Since this audience may be unfamiliar with U.S. policy debates of the 1990s, let me give you a brief account of what went on.

In the second half of the decade, U.S. economic growth was strong and accelerating. Unemployment was low, approaching rates unseen since the 1960s. In these circumstances, inflation was supposed to rise—if you believed in the Phillips curve and prevailing views of output gaps, capacity constraints and the NAIRU. That is what the Fed staff's models were saying. In his book, Governor Meyer tells how he and nearly all the other Fed governors and presidents around the FOMC table concluded that monetary policy should be tightened to head off the inevitable price increases. 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 pushed the wrong buttons and slowed the economy. According to some back-of-the-envelope calculations by economists 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 being right on the critical calibrations of monetary policy 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—that accelerating productivity had begun to alter the traditional relationships among economic variables. Greenspan is a great listener and very perceptive. He had been hearing from business leaders that the revolution in information technology had allowed their companies to reap rapid gains in output and cut costs. He understood what that meant for the economy as a whole.

In the realm of macroeconomic theory, ideas that supported Greenspan's policy stance were already taking shape. A leader in these intellectual developments was one of the great minds of the economics profession, who, I can claim with pride, has been a Dallas Fed consultant for more than a decade. I'm talking about 2004 Nobel laureate Finn Kydland. He and co-winner and co-author Edward Prescott, an economist affiliated with the Minneapolis Fed, had determined as early as 1982 that supply-side shocks like those hitting the United States in the 1990s were the most important factor in post–World War II business cycles.

According to Kydland and Prescott, productivity gains, a frequent source of supply-side shocks, had accounted for as much as two-thirds of the U.S. economy's fluctuation after 1945. They concluded that, at least for the United States in recent decades, fluctuations in the price level have been countercyclical. Put differently, changes in the price level tend to be below trend when economic activity is above trend. In 1997, by the way, Kydland and our own Dallas Fed economist Carlos Zarazaga found that the price level in Argentina exhibits the same countercyclical pattern Kydland and Prescott uncovered for the United States.

Looking at the graphs and equations of the Kydland and Prescott model is not exactly like contemplating Velázquez's *Las Meninas*, but it nonetheless has the same revolutionary significance. Kydland and Prescott rocked the profession. When it comes to monetary policy, their findings had far-reaching implications. Their work led to policy prescriptions that ran contrary to the prevailing wisdom: In the presence of a productivity surge, the Fed should not tighten but should instead let the economy enjoy the ride without fearing a rise in inflationary pressures. That is the exact opposite of the recommendation suggested by the traditional views described in Meyer's book. But it is right in line with the conclusions Greenspan arrived at in a more intuitive fashion.

Before moving on, I want to review the timeline. Kydland and Prescott's initial path-breaking paper, titled "Time to Build and Aggregate Fluctuations," was published in 1982. More than a decade later, Meyer tells us, U.S. policymakers' primary frame of reference was still the same Phillips-curve, output-gap paradigm that Kydland and Prescott had shown inadequate for high-productivity-growth periods like the late 1990s.

Why such a mismatch between theoretical insights and central bank practices? I cannot answer that question with any authority, but I want to make an observation. There seems to be a long lag between the time a new paradigm emerges and when policymakers effectively use it to guide their decisions. This only increases my sense of urgency about the need to deepen our understanding of globalization's impact on monetary policy. Countries around the world, including this one, are feeling the effects of the productivity surge occurring in China and India—a direct consequence, by the way, of the market-friendly reforms those countries are implementing in a deliberate effort to become full members of the globalization club. We need to comprehend how the world works because knowledge gives us a better chance of pushing the right buttons.

Thinking about Globalization

The experiences of Latin America, Chairman Greenspan's intuitive wisdom and the empirical work of Kydland and Prescott all point toward the same conclusion: The old economic tool kit can no longer do the job. We need new tools—a rejiggering, if you will—of our econometric equations for a globalizing economy.

The forces of globalization can produce productivity shocks, rippling through economies in ways similar to the U.S. technology-driven shocks of the 1990s. Productivity increases abroad reduce the cost of consumer goods and imported inputs at home, helping hold down domestic inflation.

I do not see how flexible exchange rates can sever the connection between foreign productivity shocks and the domestic cost of living, although that is what traditional economic theory teaches. If domestic prices are "sticky" for any reason, the economy may react to developments abroad in different ways under flexible and fixed exchange rates. But merely acknowledging a "reaction" suggests policymakers need to know how to recognize the impacts and adjust for them. Productivity improvements in China, for example, might prompt a different reaction from the monetary authority, depending on whether Chinese products represent 1 percent, 10 percent or 50 percent of the consumers' market basket.

At this point, the debate becomes quantitative: What we central bankers must do to maintain price stability may depend on parameters that determine how local goods substitute for imports or on the nontradable proportion of the typical consumer's basket. Perhaps those who question globalization's importance are suggesting that the current values of such globalization parameters are too small to play an important role in setting monetary policy. According to that view, for all practical purposes, U.S. monetary policy should be set as if the rest of the world didn't exist.

We all know, for example, that nontradable goods account for a sizable fraction of U.S. consumer price indexes. Take housing, which can represent a quarter to two-fifths of a typical household's budget. Because houses and the land they sit on are nontradable, a decline in Chinese housing costs has no impact whatsoever on U.S. price indexes.

I do not find this argument compelling. To me, tradable goods are not limited to what can be boxed up and put on a container ship or sent abroad over the Internet. I would expand the definition to any good whose price is subject to arbitrage. I do not think it is farfetched to argue that if Paris housing prices get too high, people will relocate to other cities, like Rome or Madrid. Or even beautiful Buenos Aires. Of course, we need to discuss parameter values, such as the desirability of Buenos Aires relative to Paris at various housing price differentials. But the point remains: It is hard to think of goods that are completely nontradable under the arbitrage criteria.

Even productivity gains in foreign nontradables can have an impact on monetary policy at home. Let me suggest a plausible transmission channel. A recent study by Emek Basker of the University of Missouri estimates that prices for a wide range of goods—toothpaste, shampoo, aspirin, laundry detergent and the like—fall 7 to 13 percent five years after Wal-Mart arrives in a city. So assume a Wal-Martization of China, which would confer on Chinese consumers the benefits of supposedly nontradable retail services. As a result of Wal-Mart's lower prices, however, real wages in China would go up, and with them demand for U.S. products. This is a scenario that might call for monetary policy response, depending again on the yet unknown values of certain globalization parameters.

How important is this aspect of the "Wal-Mart effect"? Perhaps small, perhaps large. We do not know—and that is the problem. In the spirit of exposing the sin but not the sinner, let me remind you that in the 1990s, well-respected economists published papers in top professional journals arguing that productivity shocks were not important during that decade. Now, those same scholars are busy cranking out papers to tell us that ... well ... productivity did matter after all.

I learned from Greenspan that it is important to follow one's instincts, guided in my case by my own experience and almost daily personal contact with market participants (and comforted by the knowledge that I am surrounded by level-headed, thoughtful colleagues at the Federal Reserve). I guess that is in the nature of things. Each of us has the responsibility to report the enemy's position as we see it from our vantage point on the battlefield. Scholars may need to be skeptical of the claim that globalization is becoming more important for monetary policy. From my position as a central banker, using insights gathered before I arrived at the post, I have a responsibility to communicate the opposite. My business contacts talk and act as if the globalization now under way will bring another decade of intense competition. This 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 labor productivity growth can stay near 3 percent, monetary policy can accommodate relatively faster growth without igniting inflation.

I understand the formidable theoretical and empirical challenges of establishing a connection between globalization, productivity and inflation. It could take us a long time to establish such relationships with some confidence, although I pray it will not take as long as the 300 years it took to prove Fermat's last mathematical theorem! I am hopeful that in reasonable time, the brilliant economists at the Federal Reserve Bank of Dallas and others in the economics profession—men and women who are true economists and not just M.B.A.'s like me—will provide us with useful guidelines for how globalization impacts policy decisions.

In closing, let me remind everybody here that regardless of your views on globalization, keeping inflation in check is a central bank's sacred mission. By spurring productivity and fomenting tectonic economic change, globalization has thus far acted as a tailwind for the Fed's—and other central banks'—efforts to hold down inflation. I believe the Fed has been able to contain inflation with faster growth than would have been possible in the absence of globalization. The secular impact of enormous new capacity and factor inputs from China, India and the other new economic entrants—transmitted through globalization—has offset the price pressures on commodities and other goods that have been spurred by growing demand in those countries, as well as normal cyclical price developments.

Will the tailwinds stay with us?

Left to their own devices, I think they would remain for a significant time. But the political dimension cannot be discounted. I have been and will remain outspoken about the dangers of protectionism in the United States. Protectionism is nothing but a tax on the consumer and the businesses that use foreign inputs. Every protectionist impulse, however politically advantageous for a particular political jurisdiction or an individual industry, undercuts globalization's favorable impact on inflation. Protectionism could lead to interest rates higher than otherwise required to maintain low inflation.

Having voiced my antipathy for protectionism and interference with the positive impact of globalization on the price mechanism through political expediency, I should point out to this distinguished audience that the Congress and the executive branch of the United States have respected the Federal Reserve's independence. All of us, on the central bank side of the equation and the political side, have vivid memories of the dangers of diverting monetary policy from its goal of conducting itself so as to achieve sustainable non-inflationary growth in employment and output—even under conditions of extreme political crisis.

As a Texan, I am mindful of the story about William McChesney Martin, Fed chairman from 1951 to 1970. President Lyndon B. 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, who had until that moment been an exemplary central banker, expressed his regrets about shifting policy to suit the president. "To my everlasting shame," he said, "I finally gave in to him."

Presidents Clinton and Bush have allowed the Fed to operate with a high degree of independence. On the whole, the U.S. 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 strong U.S. economy. Just as I doubt that, without independence from the rigid econometric dicta of well-intentioned but outdated experts, monetary policy could have so adroitly harnessed, and in turn lubricated, the forces of globalization.

Thank you.