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Implications of Globalization for the Conduct of Monetary Policy

Remarks by

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Let me begin by saying that I agree with the thrust of John's remarks. He is right that globalization has not fundamentally changed the way central banks should do business. Although production chains and capital markets are more integrated across countries than before, and gross trade flows now account for a larger share of gross domestic product (GDP) in most nations, the dynamics of aggregate output and inflation remain at least qualitatively the same. Accordingly, central banks should continue to conduct monetary policy in the same forward-looking manner as they have for the past twenty years or so, adjusting policy rates in response to current and expected future movements in output and inflation, taking account of the lags in monetary policy. When exchange rates are free to adjust, this general approach to policymaking has proven effective in fostering macroeconomic stability over time in many countries.[1]

In my remarks, I will expand on another of John's points--namely, that monetary policy making has been complicated by globalization, particularly by rising trade volumes and increased capital market integration. That is true in several ways. For one thing, globalization has likely made the domestic economy more sensitive to foreign shocks, so central banks must now pay more attention to events around the globe. And, the integration of China and other countries into the world market economy has expanded the scale and complexity of the foreign developments that central banks must monitor. Finally, globalization has probably made the link between policy actions and economic outcomes more uncertain by, among other things, strengthening the role of the exchange rate in the monetary policy transmission mechanism.

Recent increases in prices for oil and other commodities illustrate some of the complications that globalization creates for policymaking. Those price increases have raised inflation worldwide while accentuating already weakening growth prospects in some countries in

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[1] David Reifschneider and Steven Kamin, of the Board's staff, contributed to these remarks. The views expressed are my own and do not necessarily represent those of other members of the Board on the Federal Open Market Committee.

recent months. Commodity prices depend on a wide range of demand and supply factors, and sorting out their various contributions can be difficult. In recent years, potential constraints on the expansion of supply, especially of petroleum, have played a role. But in addition, the emergence of China, India, and other industrializing Asian economies as major consumers of oil and other raw materials has complicated the analysis, partly because these countries exert such a strong influence on global markets and partly because the structure of their economies is changing so rapidly.

Disentangling the various global forces influencing commodity prices can be useful in assessing the implications of those prices for domestic output and inflation, and hence monetary policy. For example, it matters whether a rise in oil prices results from demand factors, such as stronger global real activity, or supply factors, such as a hurricane that shuts down production. For an oil-importing country, a demand-driven price increase would have less negative implications for domestic real activity than a supply-driven increase because an expanding world economy would help boost demand for the country's exports. For the United States, however, a rise in oil prices driven by stronger real Chinese activity would not necessarily lead U.S. export volumes to rise substantially, given the low propensity of China to import from the United States.

Policymakers focus on the inflation outlook, and so we need to consider what global forces imply for the future when assessing the inflation consequences of rising commodity prices. Will prices for crude oil and other commodities continue to rise rapidly in the face of robust growth in China and other newly industrializing economies? Or do current prices on the spot and futures markets already fully incorporate the likelihood of continued growth in those economies, in which case prices would remain near their current level? In the first scenario, climbing energy prices, for example, would continue to boost headline inflation directly and would indirectly boost non-energy prices through higher costs of production; moreover, a continuing rise in oil prices might potentially threaten the stability of long-run inflation expectations and nominal wage demands. In contrast, a flattening out of oil prices would restrain overall inflation, directly by stabilizing a key component of energy prices and indirectly by ceasing to put upward pressure on inflation through pass-through and expectational effects.

Because monetary policy has a limited ability to counter short-term price surprises, the distinction between transitory and persistent influences on inflation from oil and other factors is critical. If we were to project a continued significant rise in energy prices over the medium run, we would need to factor that expectation into the outlook for overall inflation. Doing so could have important implications for the stance of monetary policy--all the more so if we expected rising energy costs to lead to higher inflation expectations and elevated wage gains.

Still, a leveling out in oil prices seems the more likely scenario. Surprised as we have been by the rapid, extended run-up in energy costs over the past few years, one would think that the price of a storable commodity such as oil should already embody expectations of continued rapid growth in the developing economies. However, the large run-up in spot and futures prices in recent weeks indicates that market participants are still revising their views of long-term demand-supply conditions. In these circumstances, policymakers must be mindful of the uncertainties surrounding the outlook for commodity prices and the risk that past or future increases in these goods could yet embed themselves in higher long-run inflation expectations and a persistently faster rate of overall price increases.

Besides these complications, globalization has made the workings of the monetary policy transmission mechanism more unpredictable. For one, the determination of asset prices is now more dependent on conditions in financial markets worldwide, making the link between domestic policy actions and movements in the prices of bonds or equities more uncertain. For example, the correlation of quarterly changes in the federal funds rate with the variation in U.S. Treasury yields has fallen from 0.6 before 1990 to 0.3 since then. To be sure, the falling correlation probably reflects a variety of factors, possibly including more systematic and predictable monetary policies. But global financial markets also seem to have played a role; as Chairman Bernanke has pointed out, savings from abroad, especially Asia, appear to have held down intermediate and longer-term U.S. interest rates from 2004 to 2006 even as monetary policy was tightened. As we have seen in recent months, the increased integration of financial markets has also facilitated the transmission and amplification across borders of many shocks, such as changes in the perceived riskiness of certain assets and the compensation required to hold them.

The role of the exchange rate is another complication that has only grown with globalization. Of course, flexible exchange rates make it possible for central banks to achieve their domestic economic objectives. But the exchange rate is a notoriously difficult asset price to predict, and its response to any particular policy action is highly uncertain, as we found, for example, in 2001, when aggressive rate cutting in the United States was accompanied by a strengthening in the dollar. Even with an apparent decline in the pass-through of exchange rates into import prices, the increase in trade volumes arising from globalization has presumably boosted the relative importance of the exchange rate in the economy, thereby strengthening an unpredictable factor in the monetary policy transmission mechanism.

Despite the increased openness of the domestic economy to foreign shocks and greater uncertainty about the monetary policy transmission mechanism, economic volatility in the

United States and other advanced economies has declined. That stability may be attributable, in part, to the increasing ability of global product and capital markets to buffer the domestic economy against internal shocks. Because of globalization, net exports likely absorb a greater proportion of downshifts in domestic spending, foreign competition helps discipline domestic price increases, and--as a consequence of greater cross-border holdings of assets--gains and losses on domestic assets are realized in part by foreign investors. Together with the implementation of better monetary policies in many countries, these particular aspects of globalization likely contributed to the "Great Moderation."

John addresses the question of whether greater economic integration has increased the gains to be had from policy cooperation and coordination. We have seen an example recently in which policy cooperation of a particular type seemed to pay dividends. In December, simultaneous and in some cases coordinated actions by a number of central banks to supply liquidity to banks apparently helped relieve stresses in interbank funding markets. Coordination and cooperation were called for because banks today operate in many markets simultaneously, and pressures in one market can readily spill over to others, especially when the normal channels for arbitrage have been disrupted by financial turmoil. The Federal Reserve and other central banks are examining the implications of this episode for their methods of supplying liquidity and for responding to future interruptions in the flow of liquidity across markets.

Successful coordination in the provision of liquidity raises the question of whether appreciable gains might be had from coordination of monetary policies more generally. John is skeptical, and so am I. Gains from formal policy coordination never seemed large, and it is not clear that globalization has increased them appreciably. Policies agreed to under one set of circumstances may no longer be appropriate when circumstances change, as they inevitably will.

Monetary policy should be able to adjust quickly to such changes; agreements that must be renegotiated can tie policymakers' hands. That does not mean that no circumstances exist in which coordinated monetary policy actions would be beneficial, but such circumstances are probably quite rare. Ultimately, global stability depends on good performance in individual countries, and the record of recent decades suggests that, in general, good performance is most readily achieved when central banks focus on their own mandates for domestic price stability and growth.