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Globalisation, inflation, imbalances and monetary policy

Speech by

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I. Introduction

Reflecting on the venue and the theme of this conference on my way to St. Louis, it struck me that the combination is very fitting indeed. It was from here that Lewis and Clark set off to explore the unknown American West, reaching the Columbia River on the Pacific coast more than 200 years ago. Today, our exploration is more of the intellectual type, and what we are investigating and seeking to understand better encompasses the whole world, or rather “a globalised economy”, as the title of the conference says. It is a great pleasure for me to be here and share with you and the distinguished members of this panel some thoughts on the implications of globalisation for monetary policy.

The themes of this conference, the challenges of globalisation for the advanced economies, the severity and correction of global imbalances, and the evolving roles of the dollar and the euro in the international financial system, have been the subject of enriching and stimulating discussions during the previous sessions today. In my remarks, I will try to bring together these three themes from the perspectives of the euro area and of the central banker. What are the challenges of globalisation for the euro area economies and for the conduct of the ECB’s monetary policy? In answering this question, I will address the following specific issues:

- the consequences of globalisation for inflation and its dynamics;
- the implications of globalisation for the size and sustainability of global imbalances;
- the appropriate policies, globally and in the euro area, in order to effectively contribute to the orderly correction of global imbalances; and
- the role and conduct of the ECB’s monetary policy in a globalised economy.

II. Globalisation: definition and measurement

Let me start by defining the term globalisation. Various definitions have been proposed which overlap and differ somewhat in terms of scope and emphasis. I will define globalisation as the increasing integration, and thus interdependence, of national economies and the growing exchanges of technologies, information, ideas and cultures across national borders. These processes are not new, but they have gained momentum and become more pervasive in recent years, affecting all aspects of people’s lives around the world. Advances in information and communication technology as well as a growing political consensus concerning the benefits of globalisation have contributed to the accelerating pace of integration of markets worldwide.

The changes brought about by globalisation may create the impression that traditional economic reasoning and historical statistical relationships do not always hold. Globalisation, therefore, may pose challenges for policy-makers and require us to deepen our understanding of the functioning of our economies, to increase our awareness of the evolving economic processes and even to reconsider how to use the available policy instruments in a changing world. What Heraclitus, a compatriot of mine, noted a long time ago, applies today more than ever before: “The only constant is change”.

Globalisation has indeed speeded up over the past decade and especially in the last five years. To show this concretely, we need to quantify and measure this phenomenon. In order to do this we can adopt a somewhat more specific concept and a quantitative, operational definition such as the one presented in the latest World Economic Outlook published by the IMF, which defines globalisation as “the acceleration in the pace of growth of international trade in goods, services, and financial assets relative to the rate of growth in domestic trade”. These are quantities and processes we can measure. Let us look at some charts.

The value of all world exports of goods and services relative to world GDP has increased by ten percentage points (from 19% to 29%) over the past 10-15 years (see Chart 3) and it is expected to continue to grow steadily until the end of the decade. Even more impressive is the acceleration in total Foreign Direct Investment (FDI) relative to world GDP (see Chart 4). Since the late 1990s, the pace of integration in the world economy, as illustrated by the stock of inward FDI as a percent of GDP, has accelerated substantially, particularly in non-Japan Asia and in the new Member States of the European Union (see Chart 5). The charts for FDI implicitly incorporate the associated exchanges of technology, information and know-how and other factors that have strengthened the interdependence of our economies. Statistics and charts on the movement of people and the exchange of ideas, information and technology are more difficult to come by, but I believe that they would give the same sense of the velocity of the process.

III. Globalisation and inflation dynamics

What are the implications of globalisation for the functioning and performance of national economies and for the conduct of economic and monetary policies? Can we measure its overall effects on key macroeconomic aggregates, such as inflation and output growth, of individual countries? These are broad and challenging questions. I will first focus on one issue that has received attention recently and is relevant for monetary policy: the effects of globalisation on inflation and its dynamics.

Globalisation has two main direct effects on inflation, which partly counterbalance each other. On the one hand, some resources are becoming less scarce on a global scale, notably investment opportunities and skilled labour. On the other hand, other resources have become scarcer relative to world demand: these are raw materials and basic commodities, most importantly oil and other sources of energy. Let us look at each aspect in turn.

The integration of an enormous reserve of low-cost, skilled labour in the international economy has put downward pressure on import prices of manufactured goods and on wage demands in industrial economies. As a consequence, the prices of a wide range of manufactured goods have been declining. Furthermore, through various channels this process of wage moderation and reduced inflationary pressure in the manufacturing sector has affected wage dynamics also in the services sector mainly as a result of outsourcing, especially in English-speaking countries. These effects of global integration have helped reduce inflationary pressures. It is difficult, however, to estimate the size of their impact with great precision.

At the same time, certain other resources have become scarcer: the integration of rapidly growing large emerging market economies has put upward pressure on energy and commodity prices. This impact is more visible and relatively easier to quantify. In the euro area, the trend and dynamics of the consumer price level (as measured by the HICP, that is, the harmonised index of consumer prices) and of the import prices of energy, raw materials and manufactured goods (as measured by the respective import unit value indices) have been very diverse over the past decade, especially since 1999. As shown in Chart 6, since that year the import price of energy products has more than tripled, reflecting the effects of both demand and supply-side factors. The import price index of manufactured products, by contrast, has increased only moderately and indeed it has declined slightly since 2001. These developments suggest that the downward pressure on the overall consumer price inflation also reflects, to a considerable extent, the containment of domestic wage increases in industrial countries as a result of the strengthening of global competition.

So far the manufacturing-price and the wage-containing effects on inflation of globalisation seem to have partly counterbalanced inflationary pressures arising from the substantial increases in commodity prices, partly induced by globalisation. A pertinent policy question is: for how long and by how much will global competition continue to contain inflation in industrial countries? The answer to this question is not straightforward. To begin with, the overall impact of globalisation on inflation cannot be accurately estimated although several estimates have been produced of some of its partial effects. For example, IMF staff have estimated that globalisation, through its direct effects on non-oil import prices, has reduced inflation by a quarter of a percentage point per year on average in the advanced economies. But the total impact is more difficult to estimate and disentangle from the favourable influences on the recent inflation performance exerted by the significant increases in productivity growth and the enhanced credibility of

monetary policy. But if it is difficult to assess quantitatively the overall impact of globalisation on inflation, it is more difficult to predict to what extent globalisation will apply downward pressure in the future and for how long. While acknowledging that globalisation has helped to contain inflation in many sectors and in advanced economies, and will probably continue to do so, we cannot rely on it to keep inflation under control independently of global cyclical positions and monetary conditions.

Before addressing these issues, it is interesting to point to an attempt made to identify a relationship between inflation and an index measuring the extent to which a country's economy is globalised. Chart 7 shows a simple scatter diagram of the ranking of the 62 "most globalised" countries according to the annual survey conducted by AT Kearney together with the Foreign Policy magazine, against those countries' inflation rate in 2005, which is the last year of the survey. This chart suggests that, indeed, the countries ranking highest among the most globalised ones tend to have lower inflation rates, while the "least globalised" ones have higher and more diverse rates of consumer price inflation. Needless to say, the estimated relationship between inflation and a country's globalisation ranking is only indicative of the influence of globalisation on price developments, since it does not account for the effects of other determinants of inflation in each country.

In addition to the effects of globalisation on inflation through the channels I previously described, globalisation can affect both long-term inflation and its short-term dynamics by affecting a country's potential growth as well as global potential growth and the movements of capital and liquidity across borders. Recent research at the BIS and by other economists has tried to conceptualise these effects and estimate global potential growth and the associated "global output gap", pointing to evidence that the degree of global economic slack could be becoming an important factor influencing domestic cyclical conditions. Such calculations may further explain why global inflationary pressures have been rather subdued, with few signs of "second-round" effects from the sharp rise in oil prices over the past two years, partly reflecting the effects of globalisation on the demand side of the oil market. They may also help explain why inflationary pressures may be increasing in the coming quarters as the global economy continues to expand at a robust pace, greater than the estimated range of rates of global potential growth. At the same time, it should be perfectly clear that the uncertainty surrounding estimates of the rate of global potential growth (and of the global output gap) is considerable and obviously exceeds the uncertainty associated with the estimated potential growth rate of a national economy. Consequently, the usefulness of such measures is rather limited in practice and extreme caution is warranted in deriving conclusions about their impact on the dynamics of inflation.

Ultimately, global inflation will be determined over the long term by the trend increase in global liquidity. The relationship between global trend money growth and long-term inflation will depend, however, on the way globalisation affects the rate of expansion of the productive capacity of all economies as well as on its effects on the factors and mechanisms that determine the "velocity of circulation of global money".

This simple conceptual framework points to the usefulness of examining the determinants of global portfolio allocation patterns and it can also help explain the observed long-term statistical relationship between global inflation and money creation. Overall, apart from a few episodes, there was a positive correlation between long-term inflation and trend money growth in industrial countries until the mid-1990s (see Chart 8). Since that time, money growth has increased persistently, while inflation has remained subdued. While competitive pressures resulting from globalisation seem to have at least partly contributed to containing consumer price inflation in recent years, the wide availability of financial capital at low interest rates across the largest international financial markets has also contributed to the significant rise in the prices of various assets.

In particular, house prices in many industrial countries, including several euro area countries, have risen at unusually fast rates in recent years, supporting economic activity through various channels. It is interesting to note that, over this period, house price increases were highly correlated across countries, a rather surprising result considering that housing is not a traded asset. This result reflects, to a considerable extent, the very favourable financing conditions that have prevailed in most industrial countries over the past few years, as the relatively low level of consumer price inflation allowed the maintenance of accommodative monetary policies. Therefore, abundant liquidity and low interest rates contributed to asset price increases, but their effects on consumer prices were contained. More analysis and better understanding of the links between money and credit growth, on the one hand, and asset price increases and consumer price inflation, on the other, are clearly warranted in a globalised economy marked by increased competition and productivity growth.

IV. Globalisation and external imbalances

The two forces I mentioned earlier – rapid growth in large emerging market economies that have become integrated in the world economy combined with the substantial increase in energy and commodity prices – have resulted in large excess savings, especially in East Asia and in oil-exporting countries. These excess savings (that is, savings greater than the investment opportunities at home) have been channelled to industrial countries, notably the United States, financing its increasing current account deficit, which in 2005 reached a historic record, exceeding USD 800 billion, or around 6.4% of GDP. In the US, the main factors driving the widening of its current account deficit in 2005 were household borrowing and fiscal deficits, while the corporate sector remained a net saver.

Is the whole world contributing to these imbalances? And are we all affected? (See Chart 9). Not all economic areas are running large net current account positions: the US deficit is mirrored, and is made

possible, by growing surpluses in East Asia and in oil-exporting countries. In the euro area the current account has remained close to balance.

Though not all economic areas contribute equally to the external imbalances, all are affected nonetheless. The extent to which we are all affected depends on the sustainability of this constellation of international savings and investment. Despite some dissenting voices, the broad consensus view is that this constellation is not sustainable over the longer run. Some economists have suggested that official financial accounts may underestimate the value of US external assets by not accounting for know-how, research and development and brand values. If a higher value were attributed to US foreign assets, this could allow the US to run higher sustainable current account deficits. The underlying calculations hinge on many assumptions, but the fundamental observation is that US net investment income has remained positive despite the accumulation of net external debt in excess of 25% of GDP. Recent data releases, however, indicate that US net investment income has turned negative.

If the current constellation of international current account positions is ultimately unsustainable, an international macroeconomic adjustment is required which will have a global impact. One view with regard to the reabsorption of current account imbalances focuses on the role of real exchange rate adjustment via inflation differentials, nominal exchange rate changes, or both. There is evidence, however, that the scope for orderly adjustment through the exchange rate channel is limited: the responses of current account balances to exchange rate changes has been subdued in recent years, possibly because of structural changes.

One reason for this is that the sensitivity of imports to exports has increased as a consequence of the structural international integration of production. Hence, a significant acceleration in the growth rate of exports relative to that of imports (which is necessary to reduce the trade deficit) seems unlikely to occur solely in response to exchange rate adjustment. Chart 10 shows the results of a recursive estimation of the long-run response of imports to changes in the components of GDP in the US, based on a simple dynamic equation: it indicates that, indeed, the elasticity of imports to exports has grown since the early 1990s.

Current account sustainability depends also on variables that affect its financing. Foreign investors have evidently not lost their appetite for US dollar assets. Their preferences might also be influenced by factors other than return differentials on assets: for example, the special role of the US dollar as the main international reserve currency. The accumulation of large quantities of official reserves by many central banks in East Asia and in oil-exporting countries over the past three years can act as a balancing factor in the adjustment process. It has certainly increased interdependence via risk-sharing between the main international debtor and its creditors. Charts 11 and 12 show the accumulation of foreign exchange

reserves in recent years by the major surplus countries and illustrate their evolution and distribution among countries over time.

The issue of reserve accumulation has attracted much attention recently, both among academic economists and among market observers, in particular with regard to their diversification. Indeed, the emergence of the euro as an alternative reserve currency has created new opportunities for diversification. Charts 13 and 14 show that since the introduction of the euro, its share in the official foreign exchange reserves of industrial countries has increased slightly to 19.2%, but its share in the official reserves of emerging market economies has risen significantly, from less than 19% in 1999 to more than 29% of total holdings in 2006 ¹.

These developments have been the outcome of a completely market-driven process, prompted largely by the increasing credibility of the euro as a store of value, which is related, in our view, to the success of the stability-oriented single European monetary policy. From the ECB's perspective, the international role of the euro is indeed, and should remain, a process driven by market forces.

V. Multilateral strategy for addressing global imbalances and Europe's contribution

Having diagnosed the causes of global imbalances, what is the remedy? What can – and should – be done in order to bring about an orderly adjustment? I have indicated, expressing the majority view, that the root of the global current account imbalances lies mostly in the international allocation of savings and investment. In other words: external imbalances are a reflection of internal imbalances. Does this mean that countries or economic areas which are broadly in external equilibrium, such as the euro area, have nothing to contribute to the adjustment of these imbalances? Some people would say: if you are not part of the solution, then you are part of the problem. Let me briefly discuss what we believe can be the euro area's contribution to the adjustment of global imbalances. This view is consistent with the agreed G7 policy strategy aimed at achieving a turnaround in the path of global imbalances.

The role we see for the euro area is to become a stronger and steady driving force for global growth, by establishing a fully operational internal market and encouraging innovation in production and business practices, as is also set out in the structural reform agenda that we refer to as the “Lisbon Strategy”. I see a wide scope for: structural reforms in labour and product markets to enhance efficiency, productivity and labour utilisation; for policies fostering Research & Development; and for measures to enhance international competitiveness. Such reforms will gradually raise both potential and actual growth. While

¹ Figures for the currency composition of foreign exchange reserves are not reported by all emerging market countries, notably China and some oil-exporting countries.

they may not have an immediate large quantitative impact on external positions, we expect that they will contribute significantly over time and that they will have a greater effect if concentrated in the services sector. More generally, reforms that would increase the flexibility of the euro area economy would help support higher sustainable growth and enhance the economy's resilience to external shocks.

This is the “homework” that we have to do in the euro area, as reaffirmed in the most recent G7 Communiqué. And we are committed to facing up to these challenges so that the euro area can become a key contributor to a more balanced pattern of global growth. But I would like to emphasise again the paramount role of *domestic policies in general* in resolving global imbalances: I am referring to policies aimed at encouraging savings in the United States and policies that can boost domestic aggregate demand in surplus countries. In emerging markets in particular, I would like to point to the urgency of financial reforms that will decrease the precautionary motive for savings and assist the efficient channelling of savings in the domestic economies. Effective financial reforms will also support a smooth gradual move towards greater exchange rate flexibility for the currencies of emerging Asian countries with significant external surpluses and misaligned exchanged rates. For these countries, greater exchange rate flexibility would contribute to the adjustment of imbalances as part of the agreed policy strategy.

VI. The role and conduct of monetary policy

What are the implications of globalisation for monetary policy? Should its role and orientation be changed? Should the strategic framework for analysis and policy formulation be amended? Is the required analysis for setting policy becoming more demanding? The direct and brief answers to the last three questions are: no, no, and yes to some extent.

Let me briefly elaborate and conclude. It is sometimes argued that in the globalised economy monetary policy should help guide the economy's adjustment to the complex and fast-moving environment of new investment opportunities, evolving economic processes and competitive pressures associated with globalisation. It is also occasionally suggested that monetary policy should help foster the adjustment of global imbalances. Such arguments and suggestions for addressing problems of various kinds may seem to some attractive, but they have no merit because they would not provide solutions as their proponents claim. Globalisation does not affect the central role and overriding responsibility of central banks to preserve price stability. On the contrary, maintaining price stability in a rapidly evolving globalised economy that may influence the dynamics of inflation in various ways becomes more essential and challenging. The anchoring of inflation expectations to price stability in a country or economic area is also vital in a globalised economy in which adverse inflation shocks or inflationary pressures in some economies are now more easily transmitted to others and are more visible. And there is plenty of

evidence to support our position that the delivery of price stability by a central bank, and its credible commitment to continue to do so in the future, fosters sustainable economic growth and minimises output volatility.

If the role and primary objectives of monetary policy are not affected by globalisation and if the fundamental factors determining price level developments over the medium and long term are also unaffected, the appropriate strategic framework for analysis and policy formulation should remain the same. However, the analysis required for policy formulation will have to carefully take into account the various effects of globalisation on the dynamics of inflation and economic growth and of asset prices. For example: in a globalised economy the traditional measures of core inflation are more difficult to interpret and use as indicators of underlying domestic inflationary pressures; the estimates of potential output are more difficult to calculate in a robust manner; and the measurement and usefulness of output gaps are subject to greater uncertainty than is usually the case. So the bottom line is that our role and responsibilities as central bankers remain intact in the globalised economy, but the performance of our tasks may be becoming more challenging.

VII. Concluding remarks

For this reason, conferences like this one, bringing together academics and policy-makers from around the globe, are useful in developing common approaches to understand the fast-changing globalised world. In fact, I believe that a shared understanding of the common challenges we face and of the appropriate policy responses is emerging. However, as is often the case, it is action that lags behind. But I hope and expect that the strength of the analysis and the lessons from past experience will add impetus to the implementation of the necessary policies in a timely manner.

On this positive note, I should like to conclude and thank you for your attention.