Globalisation of inflation and its implications for monetary policy

Sukhdave Singh[1]

Globalisation, whether real or financial, has more significant implications for small open economies than it does for larger and more closed economies. For monetary policy, globalisation and the structural changes it has created in the global economy have influenced inflation dynamics in important ways, and perhaps in ways that we still do not fully understand. A noteworthy example of this is the role played by global developments in explaining the "great moderation" during the period before the financial crisis. A lot has been written about how the better conduct of monetary policy led to this era of price stability. I believe that factors related to globalisation played an equal, if not more important, role. Let me mention just four global developments that in my view have had, and are continuing to have, an important impact on inflation globally.

1. ***Structural changes in the global economy.*** These include the reduced energy intensity of economic activity in the advanced economies, reduced volatility in global oil prices, improved management of business inventories and the productivity boost from increased usage of information and communication technology. All these factors contributed to the period of lower inflation. However, developments such as the emergence of new energy-intensive economies, the emergence of a sizeable middle class in emerging economies and the consequent changes in consumption patterns, the growing use of food for fuel, and the financialisation of commodity markets have had the reverse effect on inflation globally.

2. ***Economic integration, trade liberalisation and global competition.*** The focus has generally been on the role of China, especially following its accession to the WTO in December 2001. China's emergence in the global trading system has had a negative impact on global prices for manufactured goods but a positive impact on input and commodity prices. But China is not the only manifestation of how globalisation is affecting inflation dynamics. The emergence of vertical production chains in Asia has raised the possibility that the disruption of production in any country could lead to regional, and even global, price shocks. The flood in Thailand in 2011 affected global prices of everything from rice to hard disk drives. Similarly, the tsunami in Japan affected car production across the world as the supply of critical car parts ran short.

3. ***Globalisation of labour.*** This is generally thought of in terms of the global supply of labour. Again, much attention justifiably has been on China and its abundant supply of rural workers. However, there is also India and Eastern Europe. This phenomenon of shifts in the global labour supply is not new. What is new this time is the sheer magnitude, with a doubling of global labour supply on some estimates. From the global economy perspective, it is a new reality. A related issue is the flow of labour across national borders. In ASEAN, a number of the more economically advanced regional countries have attracted large number of migrant workers from other regional economies. This has helped to keep labour costs low in the industries where such migrant workers are employed. This phenomenon is global. In the mid-1980s, when I was a student at the University of Texas, Spanish was heard largely in the southern states of the United States. Now, you hear Spanish spoken almost anywhere you go in the United States.

---

[1] Assistant Governor, Bank Negara Malaysia.

4. ***Globalisation of monetary policy frameworks.*** Of course, inflation targeting had taken the limelight, especially prior to the crisis, when the trend in many advanced economies was to adopt more narrowly defined policy goals. However, the more important development was that, irrespective of framework, central banks had generally adopted good practices in the conduct of monetary policy including: acceptance of price stability as a primary objective of monetary policy, committee-based decision-making, transparency and communication, and in many emerging economies, fiscal dominance had been greatly reduced. In fact, monetary frameworks of many regional central banks differ more in form than substance. A potential downside to the globalisation of monetary policy frameworks, especially as it pertains to narrowly defined mandates, is whether the exclusive focus on inflation reduced the peripheral vision of central bankers to other risks associated with monetary policy.

The point here is that factors beyond those under the control of central banks, particularly those related to globalisation, played a key role in not only realising the "great moderation" but also in the changes to inflation since. In the recent period, financial globalisation has become a key development affecting not just financial, but also macroeconomic conditions. A number of regional economies had a nasty encounter with this form of globalisation some 15 years ago during the Asian financial crisis. More recently, since the onset of the crisis in the advanced economies, we have seen some of the negative implications of financial globalisation including: financial contagion and large capital flows, volatile asset prices and the financialisation of commodity markets. However, financial globalisation, if properly managed, can also promote growth and macroeconomic stability. Within Southeast Asia, policymakers are trying to promote regional financial globalisation, for example, through mechanisms to channel savings between regional economies. Growing regional trade and investment are facilitating financial linkages among regional economies and as these financial linkages grow, they will facilitate regional economic integration.

The globalisation of the sources of inflation does raise some questions about the conduct of monetary policy and its role in ensuring macroeconomic stability. Let me just mention three points before I introduce our speakers for this session.

POINT 1: Monetary frameworks have remained largely national even as the sources of inflation have increasingly become global. If global factors are playing an increasing role in determining domestic inflation, what role does a domestically oriented monetary policy have? Increased openness of developed and developing economies has increased the sensitivity of domestic inflation to global supply and demand developments.

POINT 2: Not fully comprehending such changes could potentially lead to policy mistakes. For instance, was the "great moderation" misdiagnosed? More specifically, did central banks claim too much credit for something in which they may only have had a minor role? For the emerging economies in Asia, structural changes in these economies are exacerbated by structural changes in the global economy. This raises the risks of potential blind spots in the policymakers' knowledge of inflation dynamics in their economies.

POINT 3: Has globalisation, particularly globalisation of financial markets, increased the risk of policy contagion? More specifically, has the globalisation of financial markets made monetary policy leaky, in terms of reducing its effectiveness as a national policy tool? Conversely, has it made our national economic and financial well-being more vulnerable to the monetary policy of other economies, especially if they are big economies? This is an important question given the sustained large-scale financial repression in the advanced economies and the potential for this to create large negative spillovers into regional economies.

To address these and other issues related to the impact of globalisation on inflation in Asia and the Pacific we have two speakers this evening. They complement each other rather nicely in the sense that Raphael Auer of the Swiss National Bank will talk about "real" globalisation," while Michael Devereux of the University of British Columbia will discuss "financial" globalisation.