Kristina Persson: Globalisation, structural changes and monetary policy

Speech by Ms Kristina Persson, Deputy Governor of Sveriges Riksbank, at at seminar arranged by the Confederation of Swedish Enterprise, Stockholm, 14 April 2004.

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Thank you for the invitation to take part in this important conversation on the consequences of globalisation for Swedish economic policy. I shall primarily highlight the significance for inflation and monetary policy, although I shall also briefly discuss the increased demands for structural changes and political management entailed by globalisation.

Globalisation - or "the increasing interdependence of countries around the world as a result of growing cross-border trade in goods and services, investment and financial flows" (the IMF's definition) - is not a new phenomenon. It has been going on for some time and has given rise to rapid structural changes with considerable demands for adaptation of people and businesses. It has led to a change in the division of labour and to specialisation, as well as access to new markets, which in turn has formed a base for increased real wages and growing welfare. How well Sweden can manage these requirements for change in the future will be decisive for our economic development.

In recent years, both the scope and rate of change of the globalisation process appear to have increased. Over the past twenty years, world trade has increased twice as fast as GDP growth, direct investment has increased three times as much and both foreign exchange and equity trading have increased approximately ten times faster than GDP. There are several explanations for this, including the deregulation of the financial markets during the 1980s. Another contributory factor is that China and India are participating to an increasing degree in the global economy. China is currently the world's fourth largest trading nation, and its share of global trading has increased from 1.5 to almost 5 per cent since the beginning of the 1990s. At the same time, private consumption in China has increased from a few per cent of US consumption to the equivalent of more than one tenth.

What can explain the inflation rate slowing down?

Over the past year, lower import prices and higher productivity than expected have contributed to the Riksbank revising down the forecasts for future inflation, particularly in recent months. It was concluded in the Inflation Report published a couple of weeks ago that the unexpectedly low rate of increase in imported inflation (adjusted for oil prices) was partly due to lower international price pressure. Strong productivity growth has also contributed. There appear to be a number of structural changes behind the increase in productivity, which are at least partly connected with globalisation.

If one disregards the temporary increases in inflation caused by high prices for energy, for instance, one can observe a gradual decline in inflation over the past decade. In Sweden CPI inflation has fallen from around 5 per cent in 1994 to approximately 2 per cent in 2003. Even in a more long-term perspective, inflation shows a downward trend, which is illustrated in a figure showing inflation in OECD countries. Other parts of the world have experienced a similar development. The IMF's previous chief economist Ken Rogoff has demonstrated in an article that global inflation has fallen from 30 per cent to 4 per cent between 1993 and 2002.

Which factors could lie behind this remarkable slowdown in the rate of price increase? I believe that it is mainly a combination of three factors:

(1) A change in monetary policy with independent central banks applying inflation-targeting,

(2) IT investments enabling large-scale cost savings and

(3) Globalisation that entails, among other things, increased competition from new low-wage countries and pressurises producer countries towards greater productivity.

1. Independent central banks with inflation targets

At the beginning of the 1990s, in the aftermath of the years of overheating and crisis, a process of reorientation of economic policy began in Sweden: the tax system was reformed and combating inflation was given priority. The Riksbank decided at the beginning of 1993 to introduce an inflation target, defined as 2 per cent with a tolerated deviation interval of plus/minus one percentage point, and fiscal policy was increasingly oriented towards budget consolidation. Similar developments took place at around the same time in many other countries. The change in economic policy was particularly revolutionary in the former communist states in Europe, in China and in developing countries that had previously been inspired by the planned economy, such as India, which contributed to these countries becoming increasingly integrated into the global economy.

The fact that price stability has become an explicit target for monetary policy has thus played an important role in the slowdown in inflation over the past decade. It is only to be expected, given that inflation is a monetary phenomenon, which is ultimately determined by monetary policy and the confidence it inspires. Independence for central banks, the convergence criteria for EMU membership and a ban on financing budget deficits by printing more money are some examples of measures that have contributed to increasing confidence in the price stability target. In addition, improved communication and increased transparency have led to monetary policy becoming more predictable and more credible. This has resulted in low, stable inflation expectations, which in Sweden have on average remained close to the inflation target in recent years.

2. Increased investment in IT

As I have already mentioned, productivity has developed more strongly than expected over the past year. Unlike the situation during the second half of the 1990s, this upturn cannot be explained by increased production of ICT goods in general and telecommunications products in particular, as these sectors have experienced a sharp fall since 2001. The higher productivity growth is instead due to an unusually large rise in total factor productivity, which is usually ascribed to technological and organisational improvements.

Historically, the broader impact of technological changes has lagged since it takes time to adapt an organisation and technology to each other in order to fully take advantage of the innovations. It is therefore possible that the large-scale investment in ICT at the end of the 1990s is only now beginning to make a clear impact in the form of organisational improvements, cost cutting and higher productivity growth. In addition, ICT developments have led, by enabling more efficient production in networks and at a distance, to new sectors in the service industries being opened to trade and international competition. Another important factor in this process is the increasingly strong interaction between ICT, trade and product markets, which enables outsourcing of labour-intensive stages of goods and services production to low-wage countries.

3. Globalisation and the structural changes in the world economy

The access to new information technology is thus one of the conditions for the new trade and production patterns that are emerging. However, the slackening in price trends is a result of many interacting factors that are partly connected with globalisation:

– Increased world trade and more operators lead to greater competition

– Deregulation and privatisation will also mean that competition increases

– A greater degree of specialisation and utilisation of comparative advantages (what is known as global labour reallocation) lead to increased productivity and efficiency

– More production in typically low-wage countries leads to lower costs

All of this indicates that international price pressure should be lower during the coming years at a given point in the economic cycle.

To gain a more comprehensive picture of the significance of the structural changes for prices, it may be useful to illustrate how they interact with other factors that might influence international price pressure, such as global demand and commodity prices. Over the past few years, international economic activity has been weak, which has probably contributed to the low rate of price increase. Until a year or so ago, commodity prices were also developing weakly, but since then a relatively large upturn has occurred, while manufacturing activity has improved and global demand has increased. Despite this, prices of manufactured goods have remained subdued.

This somewhat contradictory, in historical terms, price picture is probably partly due to developments in China, where on the one hand the vigorous industrial expansion has led to a marked increase in the demand for commodities, while on the other hand the plentiful supply of low-wage labour has meant that production of cheap goods for the world market is accelerating rapidly. This clearly illustrates one of the conditions of globalisation, namely the increasing specialisation and increased utilisation of comparative advantages. These factors, among others, provide better resource allocation, increased productivity and greater efficiency, which in turn have a subduing effect on prices.

The increasing strong international economic activity and the upturn in commodity prices indicate that international price pressure will increase gradually in the future. However, the globalisation process may mean that price increases remain moderate over the coming years, despite the economic upturn. China and India together have more than 2 billion inhabitants, which corresponds to one third of the total world population. So far, only around 10 per cent of the Chinese population is estimated to be affected by the modern economy. This means that there is a very large unutilised labour reserve that could contribute to keeping down price increases for a long period of time. At the same time, it is important to remember that the integration of China and India into the global economy will not only lead to a large increase in the supply of cheap goods and services; these countries will also contribute substantial demand for goods and services from the industrialised world. It is therefore no simple matter to assess the long-term significance of China and India for global price pressure.

The integration of low-wage countries into the global economy through large-scale investment in export-driven growth is not a new phenomenon; another example is Japan, which developed in a similar manner after the Second World War. However, the size of China and India means that the adaptation process could be much more profound and prolonged this time. Moreover, this adaptation will occur in a global environment that is much more open and exposed to competition than has previously been the case.

As yet, only a small percentage of the firms in the United States and the EU, including Sweden, have moved their production to countries like China, India and the new EU members in eastern and central Europe. Large differences in labour costs in particular mean that this redistribution of production capacity can be expected to continue in the near future. This development is supported by modern IT and by falling prices for international telecommunications. In all of the new EU member states from eastern and central Europe (with the exception of Slovenia), labour costs are lower than 5 euro an hour, while in countries like Sweden and Germany the figure is around 29 euro. Labour costs are even lower in China, less than 1 euro an hour.

The low labour costs are one of the factors behind the sharp rise in direct investment in eastern and central Europe in recent years. During the period 1993 to 2002, the inflow of direct investment in most countries was between 30 and 50 per cent of GDP a year. As the new member states continue to modernise and integrate with the rest of the EU, including full membership of EMU, their powers of attraction for investments will probably increase further.

The cost savings from outsourcing could thus be substantial, as could the profits for the global economy. The profits arise because when jobs with a low value added are outsourced, labour and investment in the industrialised nations can be redirected to more highly productive sectors, which lead to an increase in productivity and lower costs for consumers. In this way global resources can be used in an optimum manner, production becomes more efficient and GDP growth in the global economy increases.

For instance, the globalisation of IT services is expected to have major effects on productivity in the near future. A study by Catherine Mann at the Institute for International Economics shows that trade and global production accounted for 10-30 per cent of the price fall on hardware products in the United States during the 1990s. This led to growth being approximately 0.3 percentage points higher each year between 1995 and 2002 than it would otherwise have been. Today, expenditure on software is increasing at twice the rate as on hardware, and this process has scarcely begun in large areas of the economy. If prices for software also begin to fall, thanks to globalisation, the second wave of productivity gains can be even greater than the first, particularly within the services sector, which has the greatest potential.

We have seen that globalisation of trade and production patterns has led to more operators, who also have lower costs, participating in the world economy. This has led to international competition becoming stiffer and prices being pushed down. Similarly, the increasing trend towards deregulation and privatisation over the past two decades has contributed to making production more efficient and raising productivity, which in turn has had a subduing effect on price trends.

The question of how globalisation and structural changes may affect the future path of inflation will probably attract increasing attention in central bank circles. If, on the one hand globalisation and new technology have led to economies having a lower inflation propensity, it may be possible to achieve a higher level of resource utilisation without inflation accelerating. Potential growth will then be at a higher level. On the other hand, increased demand from countries such as China and India combined with a synchronised economic upturn could contribute to the global output gap being closed more rapidly than we at present assume. In this case, inflation could rise earlier than anticipated.

The major question is, of course, whether the low international price pressure will endure, and, if so, how long. One factor indicating that the developments we see now are a more lasting phenomenon is the combination of more independent central banks with inflation-targeting and increased global competition. In addition, rapidly-growing low-wage countries like India and China still have some way to go before they are completely integrated into the global economy. Events that could radically alter the picture are, for instance, increased protectionism and introversion, extensive armed conflicts and irresponsible fiscal policy. Protectionism may lie close to hand as a response to increasingly troublesome competition and difficulties in adapting national labour markets and production patterns, which is indicated, for instance, by the present US debate prior to the presidential elections. However, there is little that now indicates that these factors could grow sufficiently to outweigh the trend towards increased integration and globalisation.

The conclusion is therefore that the low-inflation economy appears to have become established, although we cannot take it for granted. What consequences will this have for monetary policy in the future?

Monetary policy in a low-inflation economy

The target for monetary policy is price stability. This means that the Riksbank is as anxious that inflation should not be too low as that it should not be too high. In Sweden, the annual CPI inflation rate was negative in February, for the first time since the beginning of 1999. Is there a risk of this development continuing, and what can the Riksbank do if it does?

To begin with, it is important to distinguish between whether price trends are governed by developments on the demand side or on the supply side. A period of falling prices is often due to aggregate demand being significantly lower than the total supply of goods and services in the economy. This type of situation can arise for two reasons: One is that demand could fall heavily, for instance, as a result of households for some reason reducing their consumption. The other is that supply could increase significantly, for instance as a result of technological advances leading to increased productivity. While demand-driven deflation is connected with weak production growth, the opposite applies to supply-driven deflation. These are usually termed “bad deflation” and “good deflation” respectively.

In practice it is not so easy to distinguish between one sort of deflation and the other. Problems arise when demand is too low in relation to supply. In my opinion, there could be a possibility that the increasingly skewed distribution of income that has arisen over the past 20 years, particularly in the United States, but also in Europe and in ‘emerging markets, has led to total demand being excessively weak from a global perspective. However, to the extent that the present low price pressure is due to good productivity growth and the increased supply of cheap goods and services from China and India, it can thus be termed “good deflation”.

These positive supply shocks, combined with the declining rate of inflation, have led to an increasing number of analysts, including Fed Governor Ben Bernanke, recently drawing attention to the risk that the negative output gap could be larger than anticipated. This would mean that disinflation is more pronounced than we are currently assuming. The structural changes may have made it even more difficult to assess the economies’ long-term growth potential and consequently to estimate total resource utilisation.

It is, of course, a complicating circumstance that factors a central bank has difficulty in identifying and controlling are important to inflation trends, in both the short term and in a longer perspective. However, there is at the same time a lot a central bank can do to prevent excessively low price increases and to parry the increased complexity following in the wake of globalisation. Here I would in particular like to emphasise the importance of having a symmetric inflation target that functions as a clear, credible target for participants in the economy. I would also like to emphasise the importance of central banks’ communication in a low-inflation economy, as it is then particularly important to create stable, positive inflation expectations.

Risks of deflation

An interesting, but possibly hypothetical, question is whether there is a risk when inflation is very low of Sweden and the global economy fastening in a deflation spiral. Experiences from deflation are fortunately rather limited, but several countries suffered problems with deflation in the 1920s and 1930s. In recent times, it is primarily Japan that has experienced deflation, and there is currently a discussion underway of the causes, consequences and what would have been a better policy. The Swedish experiences from the 1930s indicate that a price stability target can contribute to slowing down a threatening deflation process.

With an inflation target of 2 per cent, it could become more common in future for inflation to be negative during individual months. It is difficult to say whether or not this is a problem, as we do not have very long experience of low inflation. Of course, there is a possibility that a more lasting deflation could arise if consumers become pessimistic. In that case it would be important for the central banks of the world to take vigorous monetary policy measures in order to maintain confidence that the inflation target will be attained.

Academic research in the field of economics usually highlights three costs of deflation. The first concerns the difficulty in reducing nominal wages. The second cost is due to the fact that deflation, if it is unexpected, results in a redistribution of wealth from borrowers to lenders. The third cost stems from the real interest rate becoming too high in relation to demand. The IMF’s report on deflation last year pointed out these costs and emphasised that monetary policy must be preventive, vigorous and forward-looking with the aim of avoiding deflation.

If deflation should nevertheless arise, what tools do we have to deal with the situation? If the scope for interest rate cuts has been exhausted, central banks must resort to other measures. These include, for instance, trying to influence interest rates on securities with a long time to maturity and creating confidence in a higher inflation rate in future. In addition, fiscal policy can be more expansionary.

A boxed article in the October 2003 Inflation Report described the Riksbank’s views on the deflation problem. The risk of deflation was portrayed as slight, given the targeted monetary policy and improved economic activity. However, there are analysts, such as the American economist Paul Krugman, who see parallels between the situation in Japan ten years ago and the American situation now, for instance with regard to the low level of resource utilisation and the aftermath of large share price bubbles. His reasoning is that it took a long time for deflation to arise in Japan and that it is therefore important to be aware of the warning signals that arise, such as the fact that the economy grows more slowly than its long-term potential rate for several years in a row.

To summarise, it can be observed that the possibility of lasting deflation cannot be ruled out, but that the central banks have good possibilities to prevent this situation arising. The most important thing in this context is that monetary policy is adapted sufficiently quickly to achieve the target level and for monetary policy communication to be reliable and clear.

The challenges of globalisation for Sweden

Experiences show that it is generally the countries that have accepted globalisation and been quick to adapt both production and policy that benefit most from this process. The major challenge therefore lies in creating dynamic conditions in Sweden to ensure that new jobs arise as old ones disappear. What are the prospects for this?

Structural changes in the wake of globalisation mean that less efficient production will be replaced by more efficient production and that sectors that do not hold up in competition will be replaced by sectors where the country has comparative advantages. Structural changes thus consist of two parts: closing down (or outsourcing) and new establishment of businesses. The Austrian economist Joseph Schumpeter called this creative destruction; old jobs and technologies disappear and new, more productive jobs arise as technology develops and production becomes more specialised.

The problem for both the economy as a whole and for individual employees is that the period of time between destruction and creation can be fairly long, whereby “friction unemployment” arises. Structural changes make tremendous demands of the capacity to change, and of flexibility in the labour market to enable employees to change sectors as smoothly as possible. To facilitate this process, it is also important to offer support in the form of education and retraining.

There is considerable potential for a larger number of jobs and more highly qualified jobs, as well as increased productivity and lower prices, if the as yet relatively protected services sector is exposed to greater competition. As far as Sweden is concerned, this applies to areas such as foodstuffs, the rental market, the construction industry and in particular the large public sector. A comparison with the EU shows that while 32 per cent of total consumption in Sweden was entirely exposed to competition in 1999, the corresponding figure for the EU on average was 45 per cent.

In order to realise the EC Treaty’s linchpin of free competition and free movement of services, the European Commission put forward a directive in January this year that aims to create a real single market for services by 2010. The sectors covered by this comprise around 50 per cent of the economic activity within the EU, and not least small and medium-sized companies. In practice, it can be difficult to reconcile the numerous national laws regulating the services sector with the ambition of creating free competition. Nevertheless, whatever happens, many of the new jobs created in the future will be in the services sector, in both the private and public sectors.

Final remarks - some political reflections

Globalisation has not merely liberated production capacity; it also limits the national state’s influence over the terms for production and employment. There are two possibilities available to compensate this loss: One is to increase the power of attraction in relation to capital and competence on the international markets, which can lead to new businesses being established in, or moved to, Sweden and thereby to new jobs and increased growth. Attractiveness can refer, for instance, to stable rules for economic policy and entrepreneurship, well-educated labour and spearhead competence, good quality of life, access to risk capital, good infrastructure, internationally pioneering technology and research environments as well as efficient incentive and taxation systems.

The other possibility is an international political cooperation to balance market forces. This entails, among other things, creating the conditions for taking responsibility for the environment, fairer distribution of income policy and investments in infrastructure, research and development. For Sweden, the EU is the arena closest to hand for cooperation between countries in ensuring that the long-term perspective, social conditions and the best interests of society are taken into account in economic developments.