Donald L Kohn: Reflections on globalization and policies

Remarks by Mr Donald L Kohn, Vice Chairman of the Board of Governors of the US Federal Reserve System, at the European Economics and Financial Centre Seminar, House of Commons, London, England, 6 July 2006.

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I am pleased to have the opportunity to return to the Houses of Parliament. I say "return" because I appeared here once previously, before the Treasury Select Committee to testify on my report on monetary policy processes at the Bank of England. Two memories stand out from that visit: One is of the mouse that ran across the floor as we were eating lunch - I am sure it could not have been a rat in these precincts; the other is of the thoughtful, informed character of the give and take with the members of the committee, who, perhaps, were just being relatively nice to a visitor from a central bank with only ninety years of history at the time.

In the past few years, the global economy has enjoyed low inflation and robust growth. This is an experience to which policymakers of all varieties have contributed. But today I am not going to address the prospects for the global economy to extend that progress in the near term. Chairman Bernanke, in his congressional testimony later this month, will address the immediate outlook for activity and prices in the United States and the global economy more generally, and the recent conduct of monetary policy. Instead, I thought I would step back and think about the implications of some longer-term trends for economic performance and for policies, monetary and other. In particular I want to concentrate on several aspects of the reduction of barriers to trade, capital flows, and labor migration - often encapsulated in the word "globalization." First, I will talk about the extent to which globalization has itself contributed to the low-inflation environment in the United States. But the freer flows around the globe have probably also contributed to the size and persistence of global imbalances - the current account deficit of the United States and the surplus of the rest of the world. I will next spend a few minutes on the causes of these imbalances, how they might unwind, and the policies that should be put in place to raise the odds on orderly adjustment.[1]

Globalization and inflation

Although inflation is ultimately a monetary phenomenon, it is important to stress the word "ultimately" in that formulation. The long run in which monetary policy exerts its influence on nominal magnitudes is the summation of individual short runs in which pressures in labor and product markets help to shape price dynamics. In the world in which we live, it seems natural to expect, as others have argued, that the greater integration of product and financial markets would have exerted some downward pressure on inflation. I cannot look back at the experience in the United States over the past decade without discerning the imprint of such forces. The opening up of China and India, in particular, represents a potentially huge increase in the global supply of mainly lower-skilled workers. And it is clear that the low cost of production in these and other emerging economies has led to a geographic shift in production toward them; from a U.S. perspective, the ratio of imported goods to domestically produced goods has risen noticeably in recent years.

However, the extent of the disinflationary forces let loose by this shift in the pace of globalization is less obvious. The United States is more open, but it is also large in size and scope. Many U.S. goods and most services are still produced domestically with little competition from abroad. In addition, the significant expansion of production in China and elsewhere has put substantial upward pressure on the prices of oil and other commodities, many of which are imported for use as inputs to production in the United States. While we can point to types of goods for which prices are restrained by forces from abroad, the net effects of globalization on domestic inflation of all goods and services need not even be negative, especially in today's environment of strong global growth.

One challenge in assessing the effect of increased globalization is the paucity of empirical research on this issue, which is understandable given the shortness of the span over which these forces have

[1] These views are my own and not necessarily those of other members of the Board of Governors and the Federal Open Market Committee.

been particularly acute. Nevertheless, the existing research does highlight several channels through which globalization might have helped to hold down domestic inflation in recent years. These channels include the direct and indirect effects on domestic inflation of lower import prices, a heightened sensitivity of domestic inflation to foreign demand conditions and perhaps less sensitivity to domestic demand conditions, downward pressure on domestic wage growth, and upward pressure on domestic productivity growth.

Let me summarize the empirical evidence from work on U.S. inflation my colleagues and I have done at the Federal Reserve Board, as well as from our readings of other studies. In the United States, the increase in core import prices since the mid-1990s has averaged about 1-1/2 percentage points less per year than the increase in core consumer prices. According to our model, the direct and indirect effects of this decline in the relative price of imports held down core inflation by between 1/2 and 1 percentage point per year over this period, an estimated effect that is substantially larger than it would have been in earlier decades. However, much of the decline in import prices during this period was probably driven by the appreciation of the dollar in the late 1990s and the effects of technological change on goods prices rather than by the growing integration of world markets. In addition, import prices have risen at least as rapidly as core consumer prices over the past several years and thus no longer appear to be acting as a significant restraint on inflation in the United States.

A second aspect of the hypothesis is that as economies become more integrated, their domestic inflation will be less sensitive to domestic demand pressures and more sensitive to foreign demand conditions than it was earlier. While this seems eminently plausible, recognize that this is a partial-equilibrium effect, identifying one, among many, determinants of inflation, and consequently difficult to verify empirically.

Most researchers, in fact, agree that inflation in the United States is less sensitive to domestic demand conditions today than it was twenty years ago. But numerous researchers have attributed this persistently low inflation to the improved credibility of monetary policy. In that regard, most of the decline in the sensitivity of U.S. inflation to the domestic unemployment gap occurred in the 1980s - too early to be associated with the more recent acceleration in the pace of globalization and more coincident with the sea change in the attitude toward inflation worldwide.

This aspect of the globalization hypothesis, however, would be bolstered if the decline in the sensitivity of inflation to domestic demand was accompanied by an increased sensitivity to foreign demand. Efforts to find such a link have met with mixed results, with some researchers having found large effects and others having found no effect. Our own analysis of this issue indicates that these results are sensitive to how the foreign output gap is defined and to how the inflation model is specified, suggesting that any effect may not be especially robust. That said, the difficulties with measuring slack in the U.S. economy are compounded when describing the global economy, making settlement of this issue especially difficult.

Similarly, the evidence that globalization has helped to restrain unit labor costs in recent years is not definitive. One hypothesis is that the increase in the supply of low-skilled workers associated with the emergence of China and other East Asian countries as low-cost centers of production has damped the growth of nominal wages in the United States. But a stable statistical relationship between labor compensation and various measures of globalization has eluded researchers. However, many of the changes are relatively recent, giving empiricists few observations. And, in that regard, the recent behavior of some, though not all, measures of aggregate compensation seem to have been somewhat lower than models would have predicted. Of course, several purely domestic factors could help to account for any shortfall, such as the aftereffects of the unusually sluggish recovery in job growth early in this expansion or a possible downward drift in the natural rate of unemployment. But it also is a pattern that would be consistent with downward pressures from an expansion in global labor supply. In support of this link, some studies have found a relationship between industry wage growth and import penetration, and between the relative decline in wages of low-skilled workers and trade, but the effects are generally small.

A second possibility is that globalization has restrained unit labor costs by raising productivity. Increasing volumes of trade should bolster productivity as economies concentrate their resources in those sectors in which they are relatively more efficient. But I have seen little direct evidence on the extent to which globalization may have boosted aggregate productivity growth in the United States in recent years. Nevertheless, research at the Board finds that multinational corporations, which may have greater opportunities to realize efficiencies by shifting production locations, accounted for a disproportionate share of aggregate productivity growth in the late 1990s. And some microeconomic

studies have found a relationship between global engagement and productivity at the firm level. Thus, it seems possible that the persistently high growth rates of multifactor productivity in recent years in the United States may partly be due to the productivity-enhancing effects of globalization. However, these effects should not be unique to the United States. The fact that many other advanced economies facing similar competitive pressures are not experiencing the same outcome gives me pause.

This evidence suggests that the old line of Churchill - that two economists give three different answers to any question - still holds. My own assessment is that, quite naturally, the greater integration of the U.S. economy into a rapidly evolving world economy has affected the dynamics of inflation determination. Unfortunately, huge gaps and puzzles remain in our analysis and empirical testing of various hypotheses related to these effects. But, for the most part, the evidence seems to suggest that to date the effects have been gradual and limited: a greater role for the direct and indirect effects of import prices; possibly some damping of unit labor costs, though less so for prices from this channel judging from high profit margins; and potentially a smaller effect of the domestic output gap and a greater effect of foreign output gaps, but here too the evidence is far from conclusive. In particular, the entry of China, India, and others into the global trading system probably has exerted a modest disinflationary force on prices in the United States in recent years.

Moreover, we should recognize that these could be one-off effects to the extent that they reflect the global imbalances that I will speak about next, rather than just the integration of emerging-market economies into the global-trading system. If so, any disinflationary effects could dissipate or even be reversed in coming years. For example, the fact that China and some other emerging-market economies have resisted upward pressure on their exchange rates and are running trade surpluses has undoubtedly contributed to their disinflationary effects on the rest of the world. The prices of their exports are lower than they would be if market forces were given greater scope in foreign exchange markets, and they are supplying more goods and services to the rest of the world than they themselves are demanding. These imbalances are not likely to be sustained indefinitely. The elevated rates of national saving in these economies - and, in some, relatively restrained rates of investment - are not likely to persist in the face of ongoing improvements in the functioning of their financial markets, increases in the depth of their product markets, and fuller development of economic safety nets. As individuals in these countries are increasingly drawn to investing at home and consuming more of their wealth and as their real wages catch up to past productivity gains, the upward pressures on these countries' currencies will intensify, their demand will come into better alignment with their capacity to produce, cost advantages will decline, and these economies will exert less, if any, downward pressure on inflation in the United States or other advanced economies.

Global imbalances

The first thing to keep in mind about global imbalances is their scale. The U.S. current account deficit is enormous - on the order of $800 billion or 6-1/2 percent of gross domestic product - and it is not likely to shrink substantially in the immediate future, given the current configuration of economic activity and prices around the world. Obviously, the U.S. deficit has as a counterpart an equal current account surplus in the rest of the world combined, after allowance for gaps in the statistical reporting system.

The size and persistence of these imbalances reflects two interrelated forces. First is the gap between spending and production in the United States and a similar gap of opposite sign in the rest of the world. The United States as a whole is spending much more than it is producing. Saving rates are especially low in our household and federal government sectors - both of which are spending more than their current income. This configuration is not so unusual for the government, but it is for households, where low interest rates (until recently) and the rising value and easier accessibility of housing wealth apparently have boosted spending relative to income.

Outside the United States, the shortfall of domestic demand relative to production capacity has importantly reflected weak business investment along with high saving rates, a mechanism identified by my colleague, Chairman Bernanke. Low levels of investment relative to profits, sales, and the cost of capital are global, including in the United States. Indeed, it is one reason interest rates have been so low through much of the recent global expansion. In the United States, the shortfall in business demand has been made up for largely by the household sector, as I just noted; for a variety of reasons, that has been less the case in many other countries, especially in Asia, and these countries have, in effect, relied on exports to fill the gap between demand and potential production.

The second force affecting global imbalances has been the continuing strong demand for dollar assets, without which exchange rates and other prices already would have adjusted to limit the growth of the imbalances. Arguably, it was this strong demand, in response to the step-up in productivity growth in the United States and the Asian financial crisis, that appreciated the dollar in the late 1990s and initiated the string of large U.S. current account deficits. But the demand has continued this decade, albeit with some fluctuations, financing the growing U.S. current account deficit.

Private investors apparently perceive opportunities for relatively high returns on dollar assets in light of the more rapid growth of productivity in the United States than in many other industrialized economies. The attraction of dollar assets likely also is enhanced by the liquid nature of the markets in which they trade and because as collateral these assets are protected by the rule of law and have been a safe haven in times of stress. The globalization of financial markets and the increased willingness of investors to look beyond their own borders for opportunities may well have facilitated the transfer of savings needed to sustain the U.S. current account deficit. In that regard, both the pull of global demands for our assets as well as the push of our needs to finance our trade imbalance explains the current conjuncture.

Foreign official holdings of dollar assets also have risen substantially, especially in Asia. Governments there apparently read one lesson of the financial crisis of the 1990s as the need for a large war chest of reserves. In addition, against the backdrop of very high private saving rates, they may be concerned about their ability to generate sufficient domestic demand to provide employment opportunities, in some cases for the growing numbers of people who want to shift from agriculture to higher productivity jobs often in urban areas.

Although private and government demands for dollar assets have allowed the U.S. current account deficit and foreign surpluses to persist, these imbalances are not sustainable indefinitely. In the United States, both public and private saving will need to rise to meet the oncoming needs of an aging population. At some point, risk-adjusted returns on investments in the rest of the world will begin to look favorable relative to holding dollar assets. Dollar assets are becoming an increasing proportion of non-U.S. portfolios; this can continue for a time, but not forever. At some point, the United States is going to need to finance its imports with the proceeds of its exports, not with foreign saving.

Experience with current account adjustments by industrialized economies - for example, by the United States in the 1980s - suggests that the transition to a more sustainable configuration is not likely to be disruptive. But we cannot be sure, particularly because the U.S. experience is unique given the dollar’s role as a reserve currency and Americans’ relatively favorable returns on assets held abroad. The world economy is in uncharted territory with regard to the size of the imbalances. Various asset markets have experienced rather sharp fluctuations in prices in recent decades, some of which have threatened disruption in the United States and have contributed to sluggish growth elsewhere, as in Japan following the real estate boom and bust; we certainly cannot rule out the possibility of further sharp asset price movements as product prices and spending adjust. Recent research reinforces the common-sense conclusion that no single policy or private action will be sufficient to effect the necessary changes. Adjustment will need to proceed along several dimensions at the same time, including changes in relative prices and in domestic demand around the globe.

The role of policy

That observation brings me to my final topic - the role of public policy in addressing these imbalances. Sound public policies will enhance the chances that any transition will be smooth. They can contribute by facilitating needed adjustments in spending, production, and relative prices and by taking steps to foster strong, flexible product and financial markets that are resilient to more abrupt changes in asset prices and spending patterns, cushioning the effect of any such fluctuations on output and product prices.

A permanent correction to the spending imbalances in the United States must involve further progress on fiscal discipline and a long-run solution to the financing problems of entitlement programs - Social Security, Medicare, and Medicaid. Without a resolution of these fiscal problems, it would be all the more difficult to bring aggregate production and spending into balance and the resultant intensified pressures on interest rates, as the flow of foreign saving into the United States levels out or declines, would exacerbate adjustment difficulties in other sectors.

Smooth adjustment of global current account imbalances cannot be brought about by actions of the United States alone. Our trading partners also need to take steps. Indeed, were U.S. domestic

demand to moderate and provide less stimulus abroad in the form of reduced demand for exports from our trading partners, central banks in those countries would need to adjust the stance of monetary policy to maintain full utilization of resources. Moreover, in many cases, the root cause of deficient domestic demand seems to be more structural than cyclical in nature, calling for more micro-oriented measures to promote flexible and efficient labor and product markets. Such initiatives should yield higher productivity growth and more vigorous spending, boosting rates of return on capital investment outside the United States. These changes in turn would boost the demand for U.S. exports and would likely shift portfolio preferences away from dollar-denominated assets.

Other public policies, here and abroad, can have an important influence on the transition process by working to facilitate market flexibility. For example, increased exchange rate flexibility in key Asian currencies will be essential to enable the monetary authorities to contain inflation through market-oriented policies rather than inefficient direct controls. Greater flexibility also will enhance the ability of all the world's economies to adapt to the huge increases in the effective supply of labor and its productivity and in demand that has resulted from these economies becoming part of the global trading system. In addition, the United States and its trading partners should vigorously protect the current degree of the openness of their labor and product markets and should continue to pursue the difficult goal of reducing trade barriers further.

These and other types of market flexibility help facilitate needed shifts in spending and prices; without them, rigidities might impede such stabilizing changes, causing adjustments to break out forcefully in other, more disruptive ways. Increased market flexibility would also ease the macroeconomic stabilization burden placed on fiscal and monetary policy - an important consideration, given that policymakers cannot anticipate the nature and incidence of all the elements of the adjustment process.

In this regard, prudential regulation is also important because it increases the ability of policymakers to focus on stabilizing aggregate output and inflation. By ensuring that financial institutions are adequately capitalized and are managing risks well, and are in general well prepared to deal with major changes in asset prices, they are in a better position to weather any necessary changes in policy settings. Prudential regulation also decreases the risk that the actions of impaired financial institutions could disrupt the flow of credit and thereby intensify what might already be difficult adjustments. A surge in financial market innovations and shift in trading participants has paralleled the rise in global imbalances in recent years. The Federal Reserve, under the leadership of the Federal Reserve Bank of New York, has been working with other regulators in the United States and elsewhere, including the Financial Services Authority in London, along with the private sector to strengthen the infrastructures and risk management around these new markets and participants.

Finally, monetary policy plays a role in reacting to these imbalances and their inevitable unwinding. I start my thinking on this topic from the premise that monetary policy - in the United States or elsewhere - has not been a major factor behind the increases in global imbalances. As I argued a little while ago, the imbalances reflect saving and investment behavior along with demands for assets in various economies. To be sure, spending and production respond to changes in interest rates, but how the balance between the two is affected by policy is not clear. Policies to affect demand might have offsetting influences on relative prices. For example, a tighter monetary policy in the United States might damp demand but could also appreciate the exchange rate, with ambiguous effects on the current account. As a consequence, monetary policies are not well suited to initiate current account adjustments.

These imbalances certainly affect the forces of supply and demand and have consequences for price stability. At the Federal Reserve and at other central banks, we have been reacting to the changes in spending and prices that have accompanied the buildup of these imbalances in ways intended to keep inflation low and stable and our economies producing near their maximum sustainable potential. The imbalances are important to us in so far as they affect the macroeconomy, and in this regard they are just a few of the factors that the Federal Reserve considers in assessing the prospects for price and output stability. Similarly, we will need to take account of any influences on the macroeconomy of the unwinding of the imbalances when that occurs.

Continued strong demand for dollar assets will be critical to keeping that unwinding smooth and not disruptive. The Federal Reserve can contribute by being sure the public remains confident that the purchasing power of their dollar assets will not erode unexpectedly. As long as inflation expectations remain contained, relatively faster growth of the prices of imported goods for a time would be associated with only a temporary bulge in inflation and would result in a needed change in relative prices. The lesson from the 1970s, however, is that an unchecked or permanent increase in inflation

would only feed back adversely on demand for dollars. Such an unmooring of the anchor of price stability could only elevate the odds on abrupt changes in interest rates and asset prices, instability in the U.S. economy, and disorder in global adjustments.