Christian Noyer: Opening address, "Globalisation, Inflation and Monetary Policy" Symposium

Opening address by Mr Christian Noyer, Governor of the Bank of France, at the International Symposium on "Globalisation, Inflation and Monetary Policy", organised by the Bank of France, Paris, 7 March 2008.

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I am delighted to open this 5th international symposium of the Banque de France, which is an opportunity to bring together heads of central banks and international institutions, leading academics and directors of private banks, as well as representatives of industrialised and emerging countries, in order to address a topical issue of common interest and concern to us all. Today's debate will be rich and intense. The first session, chaired by Jean-Claude Trichet, President of the European Central Bank, will present the main concepts and stylised facts of globalisation and world inflation. The second session, chaired by Jean-Pierre Roth, President of the Swiss National Bank, will focus on the links between globalisation and the determinants of domestic inflation. The third session, which will take the form of a round table chaired by Nout Wellink, Governor of the Nederlandsche Bank, will examine the impact of financial globalisation on growth and asset prices. Lastly, the fourth session, chaired by Guillermo Ortiz, Governor of the Bank of Mexico, will assess the implications for the conduct of monetary policy. Jacob Frenkel has agreed to take on the difficult task of making the concluding remarks for this symposium. Jacob, like a number of others here today, epitomises the diversity of the origins of the participants in this symposium since he has served on the faculty of the University of Chicago, was the Economic Counselor and Director of Research at the International Monetary Fund and the former Governor of the Bank of Israel, and is now the Chairman of the Group of Thirty and Vice Chairman of American International Group (AIG).

I will now simply make a few brief introductory remarks.

Our colleague Mervyn King often says that monetary policy should be "boring". This is certainly not the case today. Monetary policy is interesting. But it is also, and above all, difficult. In many respects, to put it informally, the good times are behind us. Globalisation has no doubt considerably helped central banks over the past decade. Today, this is less clear cut.

We are facing a combination of two difficulties.

First, at present, for all countries, the risks for growth are on the downside and for inflation on the upside. Beyond the diversity of their mandates, this represents a common challenge for all central banks.

Second, because we are all affected, to differing degrees, by the turmoil of the past eight months in the credit markets. In the coming hours we shall hold an in-depth debate on the relationship between financial stability and price stability. But I believe that we will all agree that the conduct of monetary policy is more difficult and more uncertain in a less stable and more volatile financial environment.

I would briefly like to develop these two points.

The past two decades have been characterised, on the one hand, by an increasing integration at the global level of goods, services and capital markets and, on the other, by a reduction in inflation that has stabilised at low levels. Given the coexistence of these two phenomena, a number of observers have concluded that there appears to be a causal link. Where exactly do we stand today?

For over ten years, with the growing integration of our economies in the past few decades, powerful forces, throughout the world, have been acting to enhance price stability. Each year, the arrival of tens of millions of people on the world market increases global production capacity, in particular for tradable goods. For monetary policy in developed countries, this process is equivalent to a sequence of positive supply shocks that take the form of a spontaneous decline in the import prices of manufactured goods. All other things being equal, this terms-of-trade gain allows for a lower inflation rate for a given capacity utilisation rate. More fundamentally, and although things seem to be less straightforward in this area, it is possible that the increasing openness of our economies may have structurally changed the wage and cost formation process in a manner that favours price stability. Heightened competition triggered by imports reduces the market power of firms at the national level. However, other more indirect effects are also detectable. According to studies carried out at the Banque de France[1], the disinflationary impact of imports appears to be relatively independent of import volumes: the mere existence of potential competition renders the markets, in the words of experts, more “contestable” and influences behavioural patterns.

These disinflationary forces are still present. However, there are now other more powerful forces that have the opposite effect. The growth of emerging market economies and the rise in the living standards of their populations are leading to a surge in the demand for natural resources, food and energy, which logically has a strong and permanent impact on inflation.

Furthermore, by strengthening the magnitude of global shocks in relation to more specifically domestic shocks and favouring the international transmission of the latter, globalisation introduces a much greater synchronisation of inflationary cycles between countries, with the ensuing risks of amplification.

Overall, the effects of globalisation have ceased – probably in the long term – to be spontaneously disinflationary.

The second topic that I wish to discuss concerns globalisation and financial innovation.

There is, in my mind, no doubt about the long-term benefits of the financial innovation process that we have been witnessing over the past twenty years. However, we can also see that it may be accompanied by cyclical developments and structural changes that could potentially prove to be disruptive for monetary policy. Monetary and financial conditions are simultaneously influenced by central bank decisions, but are also increasingly affected by sometimes exogenous trends in asset prices and the pricing of risk. The monetary policy transmission mechanism is more fraught with uncertainty and less "linear" than it used to be, as shocks on asset and risk prices introduce discontinuity into financing conditions.

These developments underscore two interesting issues in particular that I would like to briefly consider.

The first concerns monetary policy responses. It will have escaped nobody’s attention that these responses are not identical across all countries. In my view, this reflects different situations more than divergent approaches. All of the world’s economies are not affected in the same way by property market shocks or developments on credit markets. In particular, we can observe that the distribution of credit remains very dynamic in Europe and that, in most euro area countries, property markets remain relatively stable.

More fundamentally, it seems to me that developments in the economic and financial context of globalisation bear out and reinforce the importance given to what, in Eurosystem parlance, we call monetary analysis, i.e. the examination and analysis of the main monetary and financial aggregates. We derive three major benefits from our monetary pillar. First, it favours the anchoring of long-term inflation expectations, which is essential when, as is currently the

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[1] Guilloux S. and Kharroubi E. (2008), “Some preliminary evidence on the globalization-inflation nexus”, *Working paper series* N°195, January

case, instantaneous pressures are strong. Second, it constitutes an integrated framework for the analysis of financial and monetary developments, which is particularly useful in times of structural change and turmoil on credit markets. Lastly, it is an indicator of underlying inflationary pressures – something that is indisputably necessary.

It is possible, indeed, that globalisation reduces the sensitivity of inflation to domestic demand owing to the possibility of increased use of external supply. This leads to a degree of decoupling of the capacity utilisation rate and the level of inflation. Under these circumstances, Phillips curves flatten and the monitoring of instantaneous inflation is no longer sufficient to detect underlying pressures. Monetary analysis therefore provides an indispensable insight into inflation developments.

The second issue concerns future developments in the world financial system. We are honoured to have among us today high-ranking policymakers and experts from both so-called industrialised countries and emerging economies. It seems clear that not everyone shares the same vision or the same approach to the processes of liberalisation and financial innovation. Yet our economies are increasingly interdependent and our financial markets ever more interconnected. It seems that the time has come to ask how, in the future, financial systems organised and regulated on such different bases and principles can co-exist, and what the systemic and macroeconomic consequences of this diversity will be. At a time when we are all reflecting on the role and future of the International Monetary Fund, this, it seems to me, is a major challenge that could be taken up by this institution.

It remains, Ladies and Gentlemen, for me to hope that this symposium gives rise to fruitful exchanges and a deeper understanding of the links between globalisation, inflation and monetary policy. I wish you an enjoyable and productive day, and give the floor to President Jean-Claude Trichet.