

Timothy F Geithner: Global economic and financial integration – some implications for central banking

Remarks by Mr Timothy F Geithner, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the Columbia Business School Center on Japanese Economy and Business' 20th Anniversary Conference, Columbia University, New York City, 26 October 2006.

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Thank you.

This is a time of remarkable evolution in the world economy. The share of the world's population exposed to the opportunities and pressures of economic and financial integration is higher now than ever before. While we almost certainly do not fully understand the precise implications of this process for long-run global growth and welfare, we know that the gains to global growth and welfare have the potential to be large and pervasive. To acknowledge this potential is to acknowledge the merits of investing substantial intellectual capital into strengthening our understanding of the policy challenges and implications of global economic and financial integration.

Compared to even a decade ago, world financial and product markets are significantly more integrated. Trade is a substantially larger and rising share of GDP, and the share of goods and services that constitute the “tradable” sector is increasing. Cross-border flows of real and financial capital have also increased dramatically - a reflection of the recent notable reduction in the degree of home bias in capital markets.

Along with the evolving pattern of cross-border flows, we've also seen profound increases in the absolute size of current account balances in both industrial economies and emerging market economies. The average absolute value of current account balances as a share of GDP is higher today than it was three decades ago, with much of the run-up occurring in the past decade, and there is less dispersion around the average. Net external positions as a share of GDP have increased over time for both industrial and emerging market economies.

A more integrated world economy brings with it the prospect of a more productive and competitive world economy. The increase in the ties between national financial systems, the greater sophistication of financial markets and financial market instruments allow risks to be shared more broadly and capital to flow to where the returns are expected to be the highest. Over time, these forces can be expected to strengthen and stabilize economic growth.

Indeed, the recent spurt of integration has occurred during a sustained period of relatively strong global growth, relatively stable and low inflation, and, although less widespread, a reduction in the volatility of growth. These improvements in outcomes have surfaced amidst a number of other important changes in the environment as well, including significant technological progress and better economic policies. But even without being able to assign precise shares to all the contributing factors, we know that greater integration and openness is likely to have been particularly important.

Despite the extent of the changes that have occurred to date, the world is some distance from a fully open or integrated economic and financial system. This observation is important because it highlights the potential for an evolving global environment to complicate the challenge of crafting economic policy, and in particular, monetary policy.

Economic theory is most comfortable with fully integrated systems in which prices and flows of goods and services along with real and financial capital responding continuously and completely to market forces. Significantly harder to capture in our models are the aspects of the world that do not fully, or quickly, adjust to market incentives, or where those incentives are hidden.

Nations still retain a range of measures designed to insulate parts of the domestic economy from trade and competition. Capital controls remain in place in a substantial number of large economies and in most smaller ones. Policymakers in many economies still have implicit or explicit mandates to limit the variability of their nominal exchange rate against that of their major trading partners.

These measures have the potential to distort the incentives of businesses and investors, and the resulting flows of goods, services, labor and capital. To understand the policy implications of globalization, one has to try to understand both the impact of these constraints and distortions and the

interaction of these policies with the forces of technology and competition that are pushing or pulling economies and financial systems closer together.

Let me focus on some of the implications of global economic and financial integration for central banks. What does globalization change and what does it not change? What complications does it introduce and what challenges does it ease? This is a vast and complicated topic, but I want to touch on some of the key issues.

In passing, let me note Federal Reserve Vice Chairman Don Kohn's recent assessment of what we know about the impact of globalization on short-run inflation dynamics in the United States and elsewhere. He noted that the evidence so far on these questions is "far from conclusive" but for the most part it suggests that to date the effects have been gradual and limited.

There are, however, some important things we know about how economic integration affects the context in which central banks operate. For example, Harvard economist Ken Rogoff and others have pointed out that to the extent that globalization increases the degree of competition, it can reduce the "inflationary bias" or, to put it differently, it can strengthen the anti-inflation credibility of a central bank. By inducing greater price flexibility, competition lowers the short-run gains to output from an unanticipated inflation, and thus permanently reduces the incentives for a central bank to try to exploit those gains. The improved credibility of the central bank's commitment to keep inflation low and stable should, in turn, allow it to deliver better inflation outcomes with fewer short-run costs to economic growth and employment.

We also know that there are a variety of mechanisms associated with globalization that lower the trajectory of inflation in the short run. For example, as the potential growth rate of an economy rises, it may experience more growth with temporarily lower inflation.

But none of globalization's effects on inflation, not even the potential reduction in inflationary bias, diminish the importance of the principal objective of central banks: setting policy to achieve low and stable rates of inflation over time. Doing this well requires the central bank to be able to discern features of the economy that it cannot know with precision - like the potential growth rate or the equilibrium real interest rate. It also requires a central bank to define and measure inflation in a meaningful way.

We live in a world where the prices of some goods and services move in different directions and at different rates. The challenge for monetary policy makers is to look at this complex and changing picture of price changes and try to gauge the forces that are operating on underlying inflation and so judge the likely future path of overall inflation.

As economies become more integrated, and as the share of goods and services that are "tradable," or are affected by trade, increases, the challenge of extracting some measure of underlying or trend inflation gets more interesting. External factors can have bigger effects on the movements of some prices. The nature and duration of the external impulse or "shock" to relative prices may be hard to discern. Rapid demand growth; commodity price volatility; the influence of a broad range of global conditions on wages: all these factors can trigger large changes in relative prices, and this makes the job of capturing underlying inflation harder.

So we have to be careful not to focus too narrowly on one particular measure. Instead we need to look at many. And indeed here in the United States we look at a range of different measures of core inflation, for example, that take energy and food prices out of the overall index. We look at these over different time horizons. We look at a variety of other measures that use different statistical techniques to strip out the more volatile parts of the index. These all have limitations, and their relative merits may change over time. Central banks approach this challenge of capturing underlying inflation differently, but ultimately we are all judged by what happens to overall inflation over time.

These issues are common to central banks everywhere. But economic and financial integration has brought particular challenges for monetary policy makers in emerging market economies. The broad pattern of exchange rate and monetary policy regimes in emerging market economies has shifted dramatically over the past decade. Most now operate a more flexible exchange rate regime, though a significant number have moved to the opposite extreme, relinquishing monetary sovereignty in favor of full monetary integration. It is true that fewer countries now operate with the fixed but adjustable exchange rate pegs - the middle ground that characterized much of the emerging world up to the crises of the late 1990s. But many still make monetary policy subject to the overriding objective of limiting the variability in the exchange rate against their major trading partners.

Viewed through this lens, it becomes apparent that the dramatic rise in the level of official reserves in much of the emerging world is not simply the consequence of a desire for a greater financial cushion against external vulnerability. It also results from the lingering aversion to letting exchange rates adjust upwards in response to market forces.

As capital markets become more open, this middle ground is harder to sustain. The broadening recognition of this is leading to a gradual increase in exchange rate flexibility, and this process is likely to continue. The pace of progress, progress in the direction of more openness to capital flows and greater exchange rate flexibility, will depend in part on the pace at which these governments are able to strengthen the resilience of the domestic financial system and set in place the broader institutional framework and supervisory regime that are vital for an open economy.

For those countries that are less far along in this transition, policy still reveals a substantial degree of ambivalence about the benefits of integration; and doubts about their ability to limit the risks in greater exposure to volatility. For most, though, this is not a question of whether to integrate, but of how to do so. And the success of this process will depend in part on the ability of central banks to conduct monetary policy in a manner consistent with achieving low inflation.

This constellation of exchange rate and monetary policy regimes among emerging market economies, including the major oil exporters, has broader consequences for the world economy as a whole. Insufficiently flexible exchange rate regimes have the potential to alter the pattern of capital flows and the price of financial assets. So do the increase in the mobility of saving and investment; the increase in the desired exposure to foreign assets (the reduction in home bias); the financial market innovation that allows for better diversification and risk sharing; and the differentials in the pace of technology adoption or workplace practices that give rise to varying productivity trends across countries. These all contribute to the patterns of capital flows and imbalances that we observe in the world today, and it is very hard to disentangle their effects from those of exchange rate and monetary policy arrangements.

That some of the forces governing capital flows and asset values are driven not by market-determined expected return but by policy measures directed at, for example, an exchange rate objective means that at least some of what we observe in global capital markets may be attributed to these distortions. The fact that official purchases of financial assets are determined by different factors than those influencing private investors suggests that we would probably see a somewhat different combination of capital flows, exchange rates and interest rates in the absence of official intervention.

To the extent that the factors affecting capital flows act to raise asset prices, lower interest rates and reduce risk premiums, it is harder for the markets to assess how much of the currently very favorable conditions are likely to reflect fundamentals and prove more durable.

If the prevailing patterns of capital flows were to exert downward pressure on interest rates and upward pressure on other asset prices, they would contribute to more expansionary financial conditions than would otherwise be the case. Among other things, this outcome complicates our ability to assess the present stance of monetary policy. It can change how monetary policy affects overall financial conditions and the economy as a whole.

Such complications can mask the effect of other forces that might otherwise find expression in risk premiums or interest rates: forces, for example, associated with the concern about fiscal sustainability in the United States or the sustainability of our external imbalances. Moreover, the policies that have played an important role in this pattern of global capital flows are already in the process of evolution, thus adding still further to the considerable degree of uncertainty we face about the longer-term outlook for the economy.

In today's rapidly evolving global economy, monetary policy makers cannot ignore the international dimension. As economies become more open, external developments inevitably affect price and output dynamics. The world may thus be more complex and, in some respects the conduct of monetary policy may be more challenging.

The external factors that have in recent years had a dampening impact on domestic inflation could, at some point, fade or reverse. And the forces that have produced this constellation of capital flows and market conditions will evolve in ways we cannot anticipate.

This obliges policymakers to devote more care to the process of understanding how change in the world affects the balance of opportunity, risk and uncertainty confronting policymakers.

And it probably makes more compelling the importance of preserving confidence in our commitment to keep inflation low and stable, so that we have the flexibility to respond to this changing world.

Ultimately, as Mervyn King, the Governor of the Bank of England, noted recently, inflation is made at home and has to be contained at home. So integration does not, and should not, limit our ability to achieve our objectives. Rather, it forces us to think harder about how our economies are evolving and how developments in the rest of the world affect our markets.

Thank you.