Axel A Weber: Challenges posed by (financial) globalisation

Lecture by Professor Axel A Weber, President of the Deutsche Bundesbank, at the University of Pune, Pune, 15 March 2007.

* * *

1 Introduction

Dear Mr. Jadhav, members of the University of Pune, ladies and gentlemen

This is my first visit to India. Although I flew in only ten hours ago, I am already quite impressed by what I have seen in my very brief time here. The official slogan of the Indian ministry of tourism is: "Incredible India!" This is almost a perfect description of my impressions so far.

My speech is entitled "Challenges posed by (financial) globalisation". Regarding globalisation, there isn't any other term which has attracted nearly as much attention over the past ten years. It is quite justified to say that globalisation and its implications are the "topic of the decade". And I think that globalisation is very likely to maintain this position in the foreseeable future.

The process of globalisation has various facets. Hence, there are many angles from which one might look at this process (for example, historical, political, social, or economic). Not surprisingly, in most of my remarks, I shall take a central banker's point of view: I shall focus mainly on the economic implications of the ongoing global integration. Besides financial aspects of globalisation, I shall cover real economic aspects as well, since both features cannot be meaningfully separated.

2 Globalisation: basic remarks and characteristics

Let me start by making some basic observations with respect to globalisation. Globalisation is a term referred to pretty often in the media, and by politicians and economists. However, there is no single definition of what globalisation actually means nor is there a single key figure for measuring its scale and evolution over time.

To me, a useful approach to defining globalisation is that, quite fundamentally, the term "globalisation" describes the ongoing process of the international division of labour. In the wake of this process, the domestic markets for goods and services, as well as the labour markets, are becoming more and more interlinked and interdependent internationally.

In the absence of a single yardstick to gauge the extent to which globalisation is evolving, it is useful to look at various developments that, in combination, reflect this process quite well. Primarily, there are three elements that characterise globalisation.

First: The steadily rising volume of global trade, whose growth rate has been exceeding that of global GDP for a long time now. On average, global trade has grown 50% faster than world GDP over the past 35 years. During the 1990s, global trade even grew twice as fast as global GDP. Among the reasons explaining this development, there are a number of factors which have particular relevance. More and more goods and services are becoming tradable. In addition, companies and economies have become more involved in foreign trade. As a result, the degree of real economic openness of many countries, measured by total exports and imports of goods and services as a ratio of GDP, has increased significantly. In the German case, the relevant figure amounted to roughly 75% last year, compared with just over 60% in 1990.

Second: The ongoing internationalisation of production processes, measured, for example, by the growing volume of foreign direct investments (FDI). FDIs have increased considerably since the 1970s. According to UNCTAD figures, worldwide FDI stocks amounted to over USD10 trillion in 2005. About 77,000 transnational enterprises with roughly 770,000 branches are involved. FDI flows among developed countries still account for the majority of FDI flows. The share of developing countries as recipients of FDIs, though, has been increasing markedly over the past few years. However, the investment has been concentrated on just a few countries, mainly in Asia.

Third: The increasing openness of many economies in financial terms, measured by the ratio of the sum of external assets and liabilities to domestic GDP. For Germany, this figure currently amounts to roughly 340%, which is three times as high as in 1990. Compared with other developed countries, Germany is among those with a high degree of financial openness. In addition, the increasing financial openness of many economies has also been reflected by strongly rising international capital flows, for example, in terms of cross-border securities transactions.

The process of globalisation has been evolving among developed countries for many decades now. Therefore, in contrast to what some observers might think, the current process of globalisation *per se* is neither new nor of special uniqueness. Rather, it is the logical outcome of efforts to further exploit the benefits of the division of labour on an international scale.

However, the pace of this process has been increasing rapidly for more than a decade now. In particular, declining costs of telecommunication and transportation have been the main drivers of this development. In addition, skill levels in many regions of the world have improved considerably as has the quality of goods and services produced in formerly rather underdeveloped countries.

Additionally, what has changed the face of globalisation is the fact that globalisation nowadays extends to a larger group of countries than in the past. More and more countries with formerly rather closed economies have opened themselves to the world market. Thus, new players have entered on to the global stage and are becoming increasingly relevant economic powers and, as a result, competitors to established developed countries.

As a consequence, the process of globalisation is leading to a shift in weights within the global economy. This shift is nothing exceptional. It is quite a natural development which simply reflects the continuously evolving global economic landscape. Within this process, China and India, in particular, have gained particular relevance over the past decade, in both economic and political terms.

In the case of India, there can be little doubt that the world's largest democracy is an emerging global economic power. Its economic growth has averaged some 8% over the past four years, placing it among the world's fastest-growing economies, while inflation has remained largely contained. Its dynamic development in foreign trade, for instance, has been quite impressive, too, thus leading to a rising share in the volume of global trade. "India goes global" – which is the title of a book that was published last year by the IMF – is an appropriate description of India's recent development.

I think that the outlined process of globalisation is among the most important factors that have fuelled the global growth dynamics we have been seeing for more than four years now. And it is likely to keep on doing so, at least in the medium-term future. IMF estimates suggest that, unless we witness rather unexpected incidents, 2007 will be the fifth consecutive year with an above-average increase in global real GDP.

After having outlined major characteristics of the current process of globalisation, let me continue by elaborating more on its implications.

3 Implications and challenges of globalisation

3.1 Real economic implications

In various parts of the world, quite a lot of people are rather sceptical if they think about the real economic implications of globalisation. In fact, there is often an indistinct fear that globalisation is mainly a risky development in which the negative consequences clearly prevail. At the heart of concerns in developed countries are the fear of loss of jobs as well as the pressure on the social security systems.

While recognising the associated challenges, the fact that globalisation is basically a positive phenomenon cannot be stressed too much. What are the benefits of globalisation? According to foreign trade theory, the international division of labour, which exploits comparative cost advantages, leads, under competitive conditions, to efficiency gains and increases the average per capita income. Compared with a situation without foreign trade, the economies concerned have greater consumption possibilities. In addition, globalisation increases product variety, which is beneficial to consumers, and enlarges the input and output markets for companies. Finally, globalisation intensifies competition, thus fostering innovation, and accelerating the dissemination of technological expertise.

But it is not only economic theory which underlines that globalisation is a positive process. Besides the theoretical aspects, empirical evidence clearly shows that there is no developed country which has opted out of the world economy and the associated global exchange of goods and services.

In turn, actively participating in the globalisation process is a prerequisite for increasing real income and the living standard of the population, not an impediment to it. To me, it is obvious that globalisation, among other factors, has made a crucial contribution to increasing wealth in more and more parts of the world.

However, the integration of formerly rather closed economies into the world economy is a process which has to be set up prudently. Otherwise, the integration process might impact negatively on the domestic economy and the well-being of its population and might increase the risk of crisis instead of enhancing the chance of prosperity. This is true of the real sector, and especially of the financial sector and the task of liberalising capital flows.

The process of opening to the world economy needs to be accompanied, among other things, by a regulatory and supervisory system that strengthens financial institutions and their ability to manage risks as well as strengthening the resilience of the financial and economic system as a whole. Thus, domestic factors, above all, are of major importance if a country wishes to benefit from globalisation.

India’s approach of liberalising its capital flows as part of far-reaching economic reforms that were initiated in the early 1990s, has proved to be a well-founded strategy. With gradual and cautious steps, which have been carefully phased and sequenced across the country, India has successfully paved the way for the stronger position we see it in today.

Let me continue by looking more closely at the relationship between globalisation and monetary policy, which is certainly of special interest to a central banker.

3.2 Globalisation and monetary policy

For central banks, it is important to understand the forces and transmission channels of globalisation in order to calibrate the monetary policy stance in an adequate way given the domestic goals of monetary policy. Two aspects are of special interest for central banks: First, the way in which globalisation changes the domestic inflation processes. Second, the way in which globalisation alters the transmission of monetary policy measures – in other words, changes in the short-term interest rate – through the economic system.

By and large, the first aspect is closely related to real globalisation, whereas the second question deals with the consequences of financial globalisation.

Globalisation and inflation

The ongoing increase in real globalisation is coinciding with a decline in inflation rates worldwide. It is not surprising that these parallel developments have been given a causal interpretation along the lines that increased real globalisation has been driving down inflation rates. And, indeed, over the past six years, the price of manufacturing imports in the euro area has been rather stable, thus dampening, other things being equal, the increase in the overall consumer price index. The same developments could be observed in other mature economies as well.

This *prima facie* evidence seems to support the view that globalisation has been a main factor in low inflation rates. However, I am quite sceptical about whether the story of globalisation adequately captures the aspects that are most important for explaining the decline in inflation rates, at least for the euro area.

First, the increase in trade volumes relative to GDP is a process that was already under way in the 1970s and 1980s. However, inflation rates during this period were substantially higher than today. Second, the effects of increased trade with labour-abundant economies will affect only relative prices. It is a well-known fact that, for the aggregate price level and its rate of change, relative price effects have no ultimate influence.

It is monetary policy that, over the medium to long term, pins down trend inflation. Globalisation might have contributed to the observable decline in cross-country trend inflation as positive price shocks have created an environment in which some central banks could use “the opportunistic approach to disinflation”. But this does not seem a convincing explanation for the bulk of industrial countries.

Third, even the immediate relative price effects of trade with emerging economies are not as benign for inflation in industrial countries as is commonly assumed. The rapid industrialisation of economies like China and India has led to sharply rising energy demand from these countries. This demand has contributed markedly to the increases in oil and commodity prices over the past couple of years. It is difficult to estimate the net effect of these developments on the overall price level in industrial countries. But, in my view, there are no reasons to assume that the overall outcome has been one of a more benign inflation outlook.

Taken all together, there are reasons for exercising caution with regard to the popular globalisation story of inflation. In other words, in my view, the real effects of globalisation on the inflation process are an issue that should be of some interest for monetary policymakers. But, at the end of the day, the importance commonly attached to globalisation forces is less clear than popular views often assume.

The decline in trend inflation worldwide is better explained by monetary policy in many countries being geared towards price stability, which is enhanced by the increasing independence of central banks in achieving their goals. Globalisation will have played a supportive role, but, in the final analysis, it is monetary policy that is responsible for medium to long-term inflation outcomes.

Financial globalisation and the transmission of monetary policy

Another aspect of globalisation with potential crucial implications has to do with the impressive growth in cross-border financial flows. As domestic asset prices are increasingly determined by global factors, the transmission channels of monetary policy measures might change as well. This is especially relevant to long-term interest rates as they constitute one of the main variables through which monetary policy influences economic outcomes and inflation.

Does globalisation mean that monetary policy is losing its leverage over domestic long-term interest rates? And if so, does this mean monetary policy is becoming ineffective?

I do not want to go too much into the details. Let me just make two points: First, even if it is true that long-term interest rates are increasingly determined on the global capital market, this by no means renders monetary policy ineffective.

One of the workhorses of international macroeconomic theory, the Mundell-Fleming model, dealt with precisely this issue some 40 years ago. And you are familiar with the result that, as long as you operate a flexible exchange rate, monetary policy becomes the more effective the higher the degree of capital mobility is. The exchange rate channel then more than compensates for the decline in the ability to influence long-term rates.

Second, one might debate whether influence over long-term rates is the most important way in which central banks achieve their goals. Issues such as the transparency, independence and credibility of monetary policy are, in my view, far more important in stabilising inflation expectations and thus safeguarding price stability.

3.3 Globalisation and financial stability aspects

Apart from its likely influence on inflation and the conduct of monetary policy, financial globalisation is increasingly affecting financial stability aspects as well. The term “financial stability” broadly describes the financial system’s ability to perform its key functions efficiently, including in stress situations and periods of profound structural change. This embraces the efficient allocation of financial resources, the settlement of payments and securities transactions, and the spreading and pricing of risk.

The importance which many central banks attach to the stability of the financial systems has increased substantially over the past few years. Regarding financial globalisation, the main reason for this development is that the internationalisation of financial flows has increased the degree of integration of the national financial systems and has therefore also heightened the risks of contagion in the event of turbulence.

Financial stability issues are, at least implicitly, also a task for central banks. What is the basic rationale behind this conclusion? The central banks’ primary objective of safeguarding monetary stability, and thereby facilitating sustainable growth and development, is based on the prerequisite of a stable financial system. In fact, monetary and financial system stability are intertwined phenomena: Monetary stability can be maintained only if the financial system is sufficiently stable to transmit monetary policy signals, for example. In turn, a stable financial system is unthinkable without monetary stability, which is a necessary, albeit not sufficient prerequisite for financial stability.

With respect to current challenges or, rather risks to financial stability, let me finally and rather briefly mention two developments which are of continuing – or even increasing – global relevance.

First aspect: global imbalances

The issue of global imbalances has been a continuous part of nearly every analysis dealing with risks to the world economy over the past few years. The term ‘imbalances’ refers to today’s uneven pattern in trade and, closely related to this, capital flows among major countries or regions. In this connection, it is the US current account that has attracted most attention among economists and policymakers as well.

Basically, today’s situation is characterised by the fact that the US, in particular, is recording large trade deficits, thus requiring substantial net capital inflows, with other countries – especially in emerging Asia, but also oil exporting countries – providing this capital through sizeable trade surpluses. Today’s uneven pattern in global trade and capital flows is being accompanied by a massive accumulation of foreign exchange reserves – mostly in these Asian or oil-exporting surplus regions. This reveals that the unprecedented accumulation of foreign exchange reserves, following large current account surpluses in many emerging market countries, is as much a part of global imbalances as is the US current account deficit.

Global imbalances are an ongoing matter of concern since they still harbour the latent risk of a disorderly unwinding, with substantial negative consequences for global economic growth, employment and stability. Thus, successfully rebalancing the global economy remains a pressing issue of global relevance. Undoubtedly, this goal can only be achieved through the combined policy actions of all parties involved.

Second aspect: search for yield in riskier assets

The search for yield in riskier assets was one of the main topics during the time of record-low interest rates in major economic regions. Key central bank interest rates as well as long-term market interest rates have moved upwards in the meantime, while remaining rather moderate by historical standards. Therefore, the search for yield in riskier assets still seems to define the actions of many market participants.

Despite the marked corrections in various financial markets quite recently, there are ongoing signs of relatively low risk premia and still increasing use of leveraged instruments, such as in the credit markets. Both developments reflect a rather pronounced feeling of complacency among many market participants. This raises the question of whether risks are appropriately reflected in the prices of various financial assets.

Why does search for yield entail risks? The search for yield in riskier assets might be a profitable investment if economic conditions remain as favourable as they are at present. However, an unexpected deterioration in the macroeconomic environment, for instance, could trigger a turnaround in sentiment with widespread repercussions. It is therefore key that risks are adequately taken into account and priced appropriately. The ongoing search for yield in riskier assets warrants further close monitoring by central banks.

4 Concluding remarks

Globalisation, defined as the process of the international division of labour, is a quite natural process in an economic environment that is evolving continuously. Basically, it is beneficial for all the countries participating in this process. However, the degree to which a country can benefit from the opportunities of open markets is determined mainly by domestically influenced factors. India has shown how to integrate successfully in the global exchange of goods and services and has become an emerging market economy of major importance.

Moreover, (financial) globalisation poses various challenges to both the domestic and global economic and monetary policy environment. The analysis of these challenges, their origin and possible implications, remains on the top of many central banks’ agenda. Coping successfully with these challenges continues to be vital to fostering sustainable growth and development in many parts of the world and is hence a matter of global interest.