

Jean-Claude Trichet: The governance of globalisation

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the Bocconi University and Corriere della Sera International Forum 2008, Milan, 12 May 2008.

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It is a great pleasure to be here today at this Forum and I wholeheartedly thank Mario Monti for having invited me. After presenting some key features of globalisation, I would like to discuss their implications for inflation and monetary policy, as well as issues related to the governance of globalisation at the international level.

Globalisation, while frequently quoted in many circles, is a rather broad concept open to many definitions. To my mind, a succinct general characterisation of globalisation in the current context can be thought of as essentially consisting of two main elements.

First, globalisation involves the entrance of new participants into the global market-place. On this count, there has been a significant expansion in global productive capacity over the last decades. This has come through the opening up of emerging economies to international trade and production, notably the greater involvement of emerging Asia in world trade, as well as Central and Eastern Europe following the collapse of the Soviet Union. On the basis of one measure, an export-to-GDP weighted labour force, the effective global labour supply *quadrupled* between 1980 and 2005, with much of the increase having occurred since 1990.¹

The second main element of globalisation is the growing interdependence between both existing and new participants via trade, production and financial market linkages. Trade in goods and services has effectively *doubled* over the last 20 years, with world imports and exports of goods and services as a share of world GDP having increased from 33.9% of world GDP in 1986 to 60% of world GDP in 2006. The increase in interdependence on the financial side has been even more impressive, with the share of gross international asset holdings in world GDP – which provides a measure of financial openness – having exhibited an *eightfold increase* over the last 25 years; now standing at more than 130% of world GDP. Indeed, global cross-border capital flows have been growing at an extremely robust pace over the last decade, increasing *threefold* as a percentage of GDP.² For the euro area over the last decade, the stock of outward and inward foreign direct investment has virtually *doubled* as a percentage of GDP since 1999.

Ultimately, these globalisation forces provide the scope for many economic benefits, including more efficient resource allocation, along with welfare gains from deepening specialisation, cheaper products, and greater product choice. But as the economic and financial effects of a changing global landscape are multifaceted, they imply several policy challenges at both the domestic and international level. I do not intend to address all of these policy challenges today, rather, I would like to focus on two specific challenges: the implications of globalisation for inflation and monetary policy, and the governance of globalisation at the international level.

¹ See IMF (2007), “*The Globalization of Labor*” (World Economic Outlook, April).

² Source: IMF balance of payments statistics.

Globalisation and its implications for inflation and monetary policy

The aspects of globalisation I have been describing thus far entail many important macroeconomic consequences for the euro area as well as other global regions.³ Perhaps most crucial from a central banking perspective is the impact on consumer price inflation. While several ways of classifying the impact are possible, I think that a simple taxonomy of globalisation's influence on inflation into two main channels – direct and indirect – provides a useful one in characterising the effects on inflation.

First, globalisation has strong direct effects on price movements of certain goods and services, and in this sense can be thought of as a shock exerting a strong influence on relative price dynamics. On the one hand, increasing trade openness seems to have had a downward impact on manufacturing price developments over the last decade or so. In the euro area, rising imports from lower-cost countries, mainly from China and the new EU Member States, appear to have put downward pressure by an average of approximately 2 percentage points per year on extra-euro area manufacturing import prices over the period 1995-2004.⁴ On the other hand, globalisation and its implications for global demand, has implied strong increases in other prices. Here, I am thinking of the upward pressure from commodity prices that derived from strong growth of commodity imports by emerging markets – both concerning energy and, more recently, food. These price rises have been impressive to say the least. Since 2002, the price of Brent oil has risen more than five-fold in US dollar terms, while the price of non-ferrous metals has risen more than three-fold. Since the beginning of 2006, such large price increases have also extended to food – with at least a doubling in the price of wheat, maize and soybeans. While I would not claim that globalisation has been the only factor underlying these price developments, it has certainly played a role through boosting demand for such commodities.

In this way, judging globalisation's impact on aggregate prices depends on the balance of these relative price movements. While relative price movements are always present and in this way need not affect aggregate inflation, they could embed short-term aggregate impacts either to the extent that the movements are sizeable or that adjustment frictions and imperfect information imply a prolonged impact. Empirical studies estimating this relative price effect suggest a small net downward impact of trade openness on annual consumer price inflation over the period of five to ten years up to 2005.⁵ Since that time, the balance of relative price shocks as characterised above could very well have become inflationary.

While influences on relative price movements of goods and services are among the most visible aspects of globalisation, its influence on inflation, however, does not stop there. A second channel involves the effects of globalisation on prices through competitive forces. Prima facie, increased competitive pressures would be expected to both dampen firm profit mark-up behaviour while also potentially altering developments in costs (such as the cost of capital and labour) which underlie price dynamics. In contrast to relative price effects, which have a complex, because bipolar, ex-ante impact on inflation, these competitive effects would be expected to unambiguously exert a moderating influence on inflation as long as impediments to competition are not in place. Evidence to validate this channel is, unfortunately, fairly difficult to gather owing to the complex nature of the markup formation process along with measurement issues. What we do observe is that the responsiveness of prices to changing demand conditions has, if anything, fallen to some extent over the last decades – which would be at odds with the notion that firms are more active in adjusting their

³ For a detailed look at the macroeconomic impacts of trade globalisation, see the ECB Monthly Bulletin article entitled “*Globalisation, trade and the euro area macroeconomy*”, January 2008).

⁴ See the box entitled “*Effects of the rising trade integration of low-cost countries on euro area import prices*” in the August 2006 issue of the ECB's Monthly Bulletin for further details.

⁵ See ECB (2008), op. cit.

mark-up behaviour in a competitive environment. In the context of globalisation, there may be reason to believe that, in integrated markets, local labour market conditions become less and less important for domestic price setting, in particular if factors of production (capital and labour) become increasingly mobile. On balance, however, empirical evidence provides mixed support for the notion that global measures of economic slack played a large role in the observed weakening in the relationship between prices and common measures of (domestic) economic slack in the euro area.⁶ Indeed, this weakening has to be judged in the context of a multitude of economic and also policy factors.

The streamlined characterisation of price effects I have described thus far, of course, does not capture the numerous and complex other aspects of globalisation relevant for monetary policy. In particular, in addition to trade globalisation and its price effects, financial globalisation could also impact on other phenomena relevant for monetary policy, such as global liquidity and long-term interest rates. I will not go through an inventory of such effects but, rather, assert that despite such a changing environment brought about by globalisation, central banks still importantly retain the ability to control short-term interest rates and – by extension – still exert a very strong influence on the domestic cost of financing.

But allow me to return to my specific example of globalisation's price effects and ask, with such impacts of globalisation on inflation, what is the best possible response of monetary policy? I would argue that guaranteeing price stability is as essential as ever. A clear and transparent definition of price stability contributes to a firm anchoring of inflation expectations in the face of considerable relative price shocks. Indeed, though the effects of globalisation on inflation I have described thus far may be operative in the short term, monetary policy ultimately determines inflation over the medium term. The current situation today provides a useful example in this respect. While monetary policy has limited power in the short term to stem external price shocks such as the sudden increase in the relative prices of food and commodities, medium term price stability can be delivered by preserving the firm anchoring of inflation expectations and by ensuring the absence of second-round effects. Indeed, the medium-term orientation of the ECB monetary policy strategy ensures that the Governing Council duly discounts short-term price volatility and transitory movements in inflation.

Domestic price stability is also a precondition for economic stability in the face of external shocks. A strong focus on domestic price stability also facilitates efficient adjustment of the economy to macroeconomic shocks. Of course, while monetary policy provides the foundation for efficient and beneficial adjustment, ongoing structural changes such as globalisation also intensify the need for more flexibility in product and labour markets. Greater microeconomic flexibility would not only allow our economy to take better advantage of the opportunities provided by globalisation, but would also facilitate macroeconomic adjustment in the wake of shocks and improve the resilience of the economy.

Taking a strict focus on domestic price stability as given, continued cooperation amongst central banks can also contribute to global financial stability, for instance in the form of dialogue between central banks and a concerted contribution to solid international financial architecture – an issue to which I will turn next. Before moving to this next topic, I should underline, however, that by international cooperation I do not mean coordination. The major economies of the world have to run their own monetary policies, attuned to their domestic conditions, in line with their responsibilities in terms of price stability. The world economy is

⁶ For instance, evidence in support of this hypothesis for sixteen industrialised countries and the euro area has been recently provided by Borio, C. and A. Filardo (2007), "Globalisation and inflation: New cross-country evidence on the global determinants of domestic inflation", BIS Working Papers No. 227. However, their results for a number of countries have been challenged by Ihrig, J., Kamin, S., Lindner, D. and J. Marquez (2007), "Some simple tests of the globalization and inflation hypothesis", Board of Governors of the Federal Reserve System, International Finance Discussion Paper No. 891. Similarly, Calza, A. (2008), "Globalisation, domestic inflation and global output gaps: Evidence from the euro area", ECB Working Paper No. 890, finds limited evidence in support of the "global output gap hypothesis" for the euro area.

becoming more integrated but at the same time the various economies that are influential at a global level remain different, with characteristics that are not alike, including in terms of market flexibility, and they have to cope with idiosyncratic shocks that can be equally different. This requires naturally different responses from the policy-makers of central banks around the world.

The governance of globalisation at the international level

As I have already alluded, to ensure that the process of globalisation occurs in an orderly manner, the international financial architecture plays indeed a crucial role. It is the institutional foundations of the global economic and financial system, which deserve credit for making sure that the tremendous benefits stemming from the integration of national economies clearly outweigh the also existing challenges. While each global financial turbulence is different and has different triggers and repercussions – think for instance of the Asian crisis of the late 1990s and the very significant global financial market correction of today –, such events have in common that they are really global. As such, they require, in addition to appropriate policy responses at the national level, also determined policy cooperation at the international level. Let me take a closer look at some key international governance structures and rules that provide mechanisms for crisis prevention and crisis resolution in the global economic and financial system. My first focus is on the surveillance activities of the IMF – in particular its multilateral surveillance as well as surveillance over exchange rates and exchange rate policies – and current efforts to adapt them to evolving needs. I will then share with you some thoughts on how the international institutions and fora are responding to the present financial situation and related episodes of turbulence and volatility.

As mentioned earlier, national economies are increasingly interconnected so that changes in the economic and financial conditions of one country, to varying degrees, impact the situation in other countries. The Fund has responded to these far-reaching developments by adjusting its surveillance over its members' economic situation and policies. Bolstering the multilateral and cross-country perspectives in its bilateral surveillance and placing greater focus on international economic and financial linkages and spillovers is indeed the right approach. Moreover, cross-checking between multilateral and bilateral surveillance should help promote policies at the national level that are consistent with other domestic policies as well as global adjustment within the international monetary system. In the context of this ongoing monitoring, which enables the IMF to combine its cross-country and cross-regional experience, I would see a clear merit in the Fund distilling national best practices.

As far as the Fund's multilateral surveillance instruments is concerned, I would like to recall that the international community agreed in Spring 2006 to expand the Fund's surveillance instruments and to launch a new supplementary consultation procedure in a multilateral format. The first such multilateral consultation has focused on the issue of global payments imbalances and involved several systemically important economies, namely China, the Euro Area, Japan, Saudi Arabia, and the United States. I do believe that the multilateral consultation is an innovative and useful tool as it brings together relevant players for a meaningful dialogue on a very specific global matter. Looking at the multilateral consultation on global imbalances, it is worth noting that all parties to this consultation are in agreement that reducing imbalances in a manner compatible with sustained global growth poses a multilateral challenge to be addressed as a shared responsibility.

Let me now turn to the events we are currently witnessing in the global financial system, which illustrate the vulnerabilities of the system and point to shortcomings on the part of the public authorities as well as in the private sector. With the global financial system still undergoing a process of de-leveraging and risk re-pricing, the risks to global and financial stability should not be underestimated. Signs of these risks, inter alia in domestic and external real and financial imbalances, should be addressed resolutely by the relevant

parties. It is therefore highly welcome that, in view of the ongoing turmoil, the international community promptly called for a concerted response aimed at identifying the weaknesses, drawing comprehensive lessons and formulating policy responses with a view to strengthening the resilience of the financial system. Work has progressed intensively both at the international as well as the EU level.

I will highlight the important work being done by the Financial Stability Forum (FSF) and its excellent report on enhancing market and institutional resilience, which was recently released to G7 Finance Ministers and Central Bank Governors. The G7 identified a number of recommendations by the FSF that are considered among the immediate priorities for implementation within the next 100 days. Financial institutions, for instance, should fully and promptly disclose their risk exposures, write-downs and fair value estimates for complex and illiquid instruments in their upcoming mid-year reporting. Moreover, the International Accounting Standards Board (IASB) and other relevant standard-setters should take urgent action to improve the accounting and disclosure standards for off-balance sheet entities and to enhance guidance on fair value accounting, particularly on valuing financial instruments in periods of stress. What is also relevant is that financial institutions should strengthen their risk management practices, including rigorous stress testing, under the support of supervisors' oversight. Finally, by mid-2008, the Basel Committee on Banking Supervision ("Basel Committee") should issue revised liquidity risk management guidelines and the International Organisation of Securities Commissions should revise its code of conduct for credit rating agencies. Additional measures that are to be implemented by end-2008 relate to strengthening prudential oversight of capital, liquidity and risk management and enhancing transparency and valuation. Moreover, the role and uses of credit ratings should be changed, the authorities' responsiveness to risk strengthened and arrangements for dealing with stress in the financial system implemented.

Other international bodies and institutions that have responded to the financial turbulences include the Basel Committee on Banking Supervision which just announced that it will take a number of steps to bolster the resilience of the banking system to financial shocks. Moreover, the IMF is sharpening its analysis of the financial sector and macro-financial linkages. It is welcome that the Fund places greater focus on financial sector analysis in Article IVs and continues its emphasis on Financial Sector Assessment Programmes. In this context, I would highlight that all 27 member states of the European Union have either already completed an FSAP or confirmed their future participation. It is welcome that a number of countries, including some systemically relevant ones, have expressed their intention to undergo an FSAP exercise.

At the EU level, the Council of European Ministers of Finance (ECOFIN) has coordinated work aimed to strengthen supervisory and financial stability arrangements. This relates to the introduction of a European mandate for national supervisors, the clarification and strengthening of the functioning of the committees of supervisors at the level of the 27 EU member states and the wider use of colleges of supervisors to re-enforce the supervision of cross-border banking groups. Moreover, a Memorandum of Understanding on cross-border cooperation in financial crisis situations between all relevant authorities in the EU, that is supervisory authorities, central banks and finance ministries, has been signed.

In sum, a number of significant initiatives are underway at the various levels of governance of the global financial system to respond to the challenges of globalisation. To ensure that the responses by the bodies and forums in charge of global economic and financial stability are effective, it is of course crucial that they collaborate closely and complement each others' efforts. This should also be the case as regards the interaction between the FSF and the IMF.

Conclusion

The phenomenon of globalisation entails many important changes to the global macroeconomic, financial landscape. Associated with this, it entails many policy challenges – both in terms of domestic macroeconomic policies and the international financial architecture.

At the domestic level, a key challenge for monetary policy is to actively monitor changes in the inflation process, while continuing to solidly anchor inflation expectations. The strong relative price movements associated with globalisation make a firm focus on price stability as essential as ever. At the same time, such a sound monetary policy framework can lay the foundations for fostering benign economic adjustment so that the euro area realises the many benefits associated with globalisation. Of course, policy challenges do not stop here – notably, greater microeconomic flexibility would also be essential to both allow our economy to take better advantage of the opportunities provided by globalisation, but would also facilitate macroeconomic adjustment in the wake of shocks and improve the resilience of the economy.

At the international level, looking at the implications for the governance of globalisation, I believe that a key contribution that the institutions and informal bodies and forums in charge of global economic and financial stability make to strengthen the resilience of the global financial system is to foster information-sharing and increase transparency. It is the access to information that facilitates investment decisions, the management of risk and market discipline. These effects are of course particularly important in times of market volatility as they lessen herding behaviour and contagion.

Moreover, with the global economic and financial landscape constantly changing, it is essential to establish market-based policy frameworks and to pursue sound domestic policies, while regularly updating the various institutions and forums that form the international financial architecture. This relates both to the format of these institutions and forums as well as to the policy issues that they deal with. Doing so ensures that the benefits stemming from the process of globalisation are maximised. As I have set out earlier, policymakers are not complacent: they do live up to this important task and adapt the international financial architecture where necessary, thereby bolstering the shock-absorbing capacity of the global financial system.

I thank you for your attention.