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Bank of Japan

Globalization and Monetary Policy

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First of all, I would like to extend my sincere congratulations to General Manager Carstens, Dr. Remolona, Chief Representative for Asia and the Pacific, and other staff members of the BIS Asian Office on the Office's 20th anniversary. Over the past twenty years, the Asian economies have experienced significant changes, particularly improvements in resilience to external shocks. The BIS Asian Office has played an important role in these improvements, including by enhancing cooperation among central banks in the region. I will touch upon the importance of regional cooperation in promoting global monetary and financial stability later, but let me first discuss price and financial stability within individual economies under globalization.

How has globalization affected price and financial stability? As we saw in the global financial crisis a decade ago, and in the Asian Financial Crisis about two decades ago, global or regional financial integration did affect domestic financial stability in many countries. While financial integration facilitates consumption smoothing and diversification of risks across countries, large and volatile capital flows carry risks for global financial stability. Compared with the effects on financial stability, what is less evident is how globalization has affected price stability. Since BIS economists, about a decade ago, proposed the hypothesis that the factors influencing domestic inflation have become increasingly global,[1] this hypothesis has attracted considerable attention. A large body of empirical studies have examined whether, and to what extent, global factors such as global economic slack and global competition have affected domestic inflation dynamics, and whether their roles have increased with global economic integration. The evidence so far, however, still seems to be inconclusive.

There could be several channels through which globalization affects domestic inflation. Most obviously, movements in import prices directly affect consumer prices. Moreover, some global factors such as international competition pressure and cross-border price differentiation of multinational corporations could affect domestic prices without actual import flows. These channels may be captured by the global output gap and global markup of price over cost as additional explanatory variables in the standard Phillips curve equation, in addition to import prices. More recently, BIS economists have demonstrated that the growing

[1] Borio, C. and A. Filardo (2007) "Globalisation and inflation: new cross-country evidence on the global determinants of domestic inflation," BIS Working Papers, 227.

importance of global value chains might be key to explaining the influence of global factors on domestic inflation.[2] The significance of these global factors has continued to be examined empirically.

For a better understanding of the role of these global factors in domestic inflation, I would like to make three points here. First, there are substantial differences between countries as to how much and through which channels globalization affects domestic inflation, depending on the country's size, income level, trade openness, and so on. For instance, Japan is a large and advanced economy but has already been deeply integrated into global and regional value chains, including with emerging economies. Its domestic output gap considerably reflects foreign market conditions through net exports. Under these conditions, the additional impact of increased competition pressure from emerging economies on domestic inflation may be limited or hard to identify in the estimation of a Phillips curve equation.

Second, various aspects of globalization, such as trade, competition, and value chains, may affect domestic inflation in different directions. While increased competition pressure and rising integration in global value chains have placed downward pressure on domestic inflation, there has been another recent trend toward increasing global market concentration, particularly in information and communication technology-intensive service industries, which may pose an upside risk to future inflation through rising markups.[3]

Third, it is important to distinguish the short-term and the long-term effects of globalization on inflation. Fluctuations in import prices have only a temporary effect on inflation, and there is little empirical evidence that the effect of global factors on the trend component of inflation has been increasing over time.[4] Inflation trends in many countries have mainly been driven by domestic factors, especially long-term inflation expectations. Developments in inflation

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[2] Auer, R., C. Borio, and A. Filardo (2017) "The globalisation of inflation: the growing importance of global value chains," BIS Working Papers, 602.

[3] Andrews, D., P. Gal, and W. Witheridge (2018) "A genie in a bottle? Globalisation, competition, and inflation," OECD Economics Department Working Papers, 1462.

[4] Forbes, K. (2018) "Has globalization changed the inflation process?" Paper presented at 17th BIS Annual Research Conference on June 22, 2018.

expectations are influenced by the actual inflation at short horizons, but it is generally considered that they are eventually determined by some anchor point at longer horizons.

This last point leads to one answer to the question how monetary policy challenges from spillovers can be met. Better-anchored inflation expectations based on clear and credible communications by a central bank would be one way to deal with the spillover of external shocks. Of course, I understand more challenging situations faced by central banks in emerging economies that are relatively vulnerable to volatile capital flows and exchange rate fluctuations. However, as shown in the IMF's World Economic Outlook, published earlier this month,[5] the anchoring of inflation expectations in emerging economies has improved significantly over the past two decades. It has also been demonstrated that further improvement in the extent of anchoring could strengthen economic resilience to external shocks, by reducing inflation persistence and limiting the pass-through of currency depreciations to domestic prices. Here I would like to briefly mention the case of Thailand, which was at the epicenter of the Asian Financial Crisis. After the crisis, Thailand moved to a floating exchange rate regime with a flexible inflation targeting framework. It then established the legal framework of monetary policy conducted by the Bank of Thailand in an independent manner. Overall, it has recorded excellent performance in price stability over the past two decades, and in recent years, the Bank of Thailand has been tackling low inflation rather than high inflation.

Finally, I would like to come back to the issue of regional cooperation, which is another way for central banks to deal with the spillover of external shocks. In the East Asia and Pacific region, we have many opportunities to discuss regional economic and financial market developments. Close communication and cooperation among central banks through these opportunities would be crucial, especially in crisis times when huge external shocks could affect domestic price and financial stability. More specifically, a number of initiatives have already been established through regional cooperation to enhance the resilience of regional economies against external shocks. The Chiang-Mai Initiative Multilateralization has been established as a regional financial safety net for crisis prevention and resolution. In addition,

[5] International Monetary Fund (2018) "Challenges for monetary policy in emerging economies as global financial conditions normalize," Chapter 3, *World Economic Outlook*, October 2018.

efforts have been made to develop local currency bond markets, which are important to eliminate the double mismatches of currency and maturity which exacerbated the debt burden at the time of the Asian Financial Crisis. In one such initiative, the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP) set up the Asian Bond Fund (ABF) in 2003, and since then the BIS has worked closely together with the EMEAP on this initiative. In sum, both closer regional cooperation and better macroeconomic policy frameworks within individual economies are important ways to deal with the spillover of external shocks and thereby promote global monetary and financial stability. I would like to conclude my remarks by once again expressing my appreciation for the role the BIS Asian Office has played over the past twenty years, especially in supporting regional cooperation among central banks.

Thank you very much for your attention.