Globalisation, labour markets and monetary policy

First reaction

- Globalisation is a *real* phenomenon
  - not obvious that it should influence *monetary* (nominal) variables
- Trade theory is all about *real* variables
  - real income
  - relative sector sizes
  - relative prices and wages
  - income distribution
- But empirically much smaller effects than one would expect from traditional trade theory

My focus

1. The inflation target and the commitment to achieve it
2. The technical relationships that the central bank has to take into account when trying to reach its inflation objective

The technical relationships

- The role of import prices
- Productivity growth
- The responsiveness of domestic inflation to the output gap
- Equilibrium output (employment)

Import prices

- Lower import price increases than anticipated may make monetary policy too restrictive

  - but only a *transitory* phenomenon

- Does a larger import share make it easier or more difficult to forecast inflation?

  - easier to forecast foreign inflation than price changes for domestic goods because of ”law of large numbers”
  - but exhange rate uncertainty makes it more difficult (though smaller pass-through than we used to believe)
  - increased uncertainty because of ”unstable” low-wage economies
  - but less uncertainty if imports are distributed over many suppliers

Productivity growth

- Globalisation contributes to higher productivity growth
  - increased competitive pressures
  - offshoring allows domestic firms to focus on the activities where they have comparative advantages
- Higher productivity growth tends to reduce inflation
- Productivity effects may be substantial
  - Frankel and Rose (2000) : 1 percentage point increase in *(exports + imports)/2 × GDP* raises GDP per capita by 1/3 percentage point
  - Amiti and Wei (2006): 1/6 of US productivity growth in manufacturing is due to offshoring

The responsiveness of inflation to the output gap

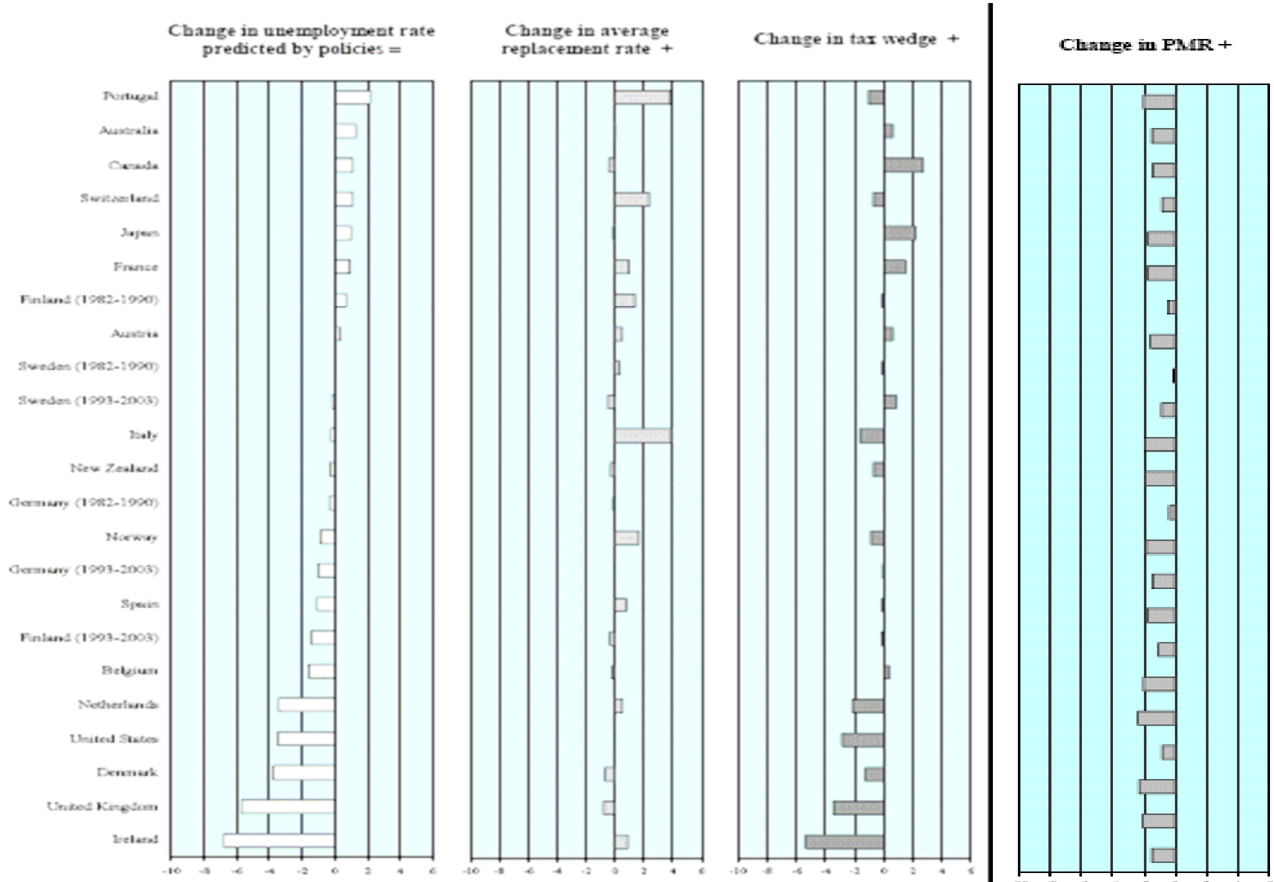
- Reduced responsiveness of CPI inflation because it is to a larger extent determined by foreign supply and demand factors
- Some evidence on lower inflation responsiveness over the last two decades (*World Economic Outlook* 2006)
- Smaller inflation effects of demand disturbances but also smaller effects of monetary policy

Equilibrium output (employment)

- Krugman argument: downward pressure on relative wages of low-skilled (possibly on aggregate real wage increases as well)
  - lower equilibrium employment if relative (real) wage rigidities
- More competition in general tends to raise equilibrium employment
  - price mark-ups are cut
  - wage moderation because rents are reduced and the sensitivity of employment and profits to real wages increased
- Equilibrium employment tends to rise if import prices fall relative to domestic output prices (real appreciation)
- - real product wages (nominal wages/product prices) can fall at the same time as real consumption wages (nominal wages/consumer prices) increase
  - empirical evidence that real exchange rate changes are an important determinant of equilibrium employment in Sweden (Lindblad and Sellin 2006)

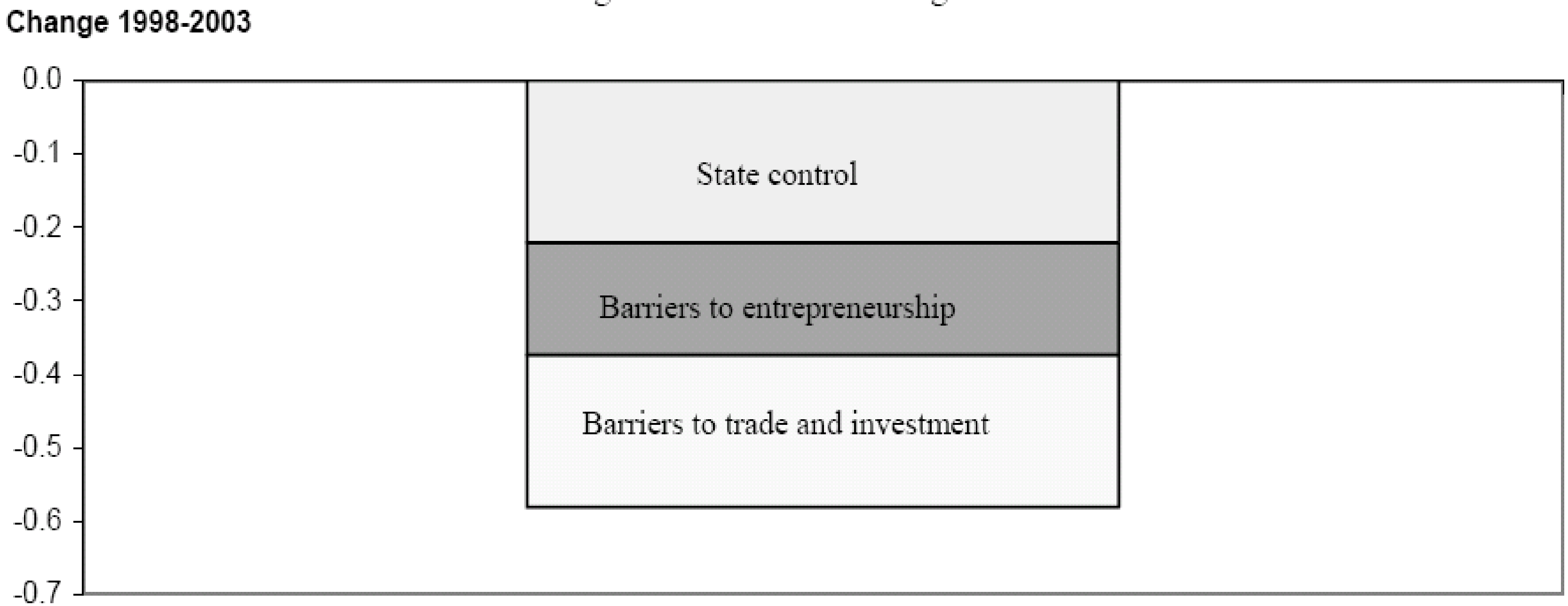
Figure 1.2. **Decomposing the impact of policies on the change in unemployment**

Unemployment effects of changes in policies over 1982-2003, on the baseline equation, in percentage points



Estimates on the basis of the unemployment rate equation in Table 1.2, column 1.
Source : Authors' estimates on the basis of data sources described in Annex 2.

Panel B. Change in OECD-wide average PMR indicator



Second set of questions

- Positive question: Are there reasons to believe that globalisation will cause central banks to change their inflation objectives?
- Normative question: Are there any good reasons for why central banks *ought to* change their inflation objectives in response to globalisation

Globalisation and the incentives to accept inflation

- Time inconsistency of monetary policy can create an *inflation bias*
  - if policy makers have an employment objective above the equilibrium rate
  - larger bias the larger the difference between the employment objective and equilibrium employment and the larger the employment gain of unanticipated inflation

- Globalisation reduces the inflation bias
  - higher equilibrium employment (Rogoff 2003)
  - more flexible prices and wages imply less scope to raise employment through unanticipated inflation (Rogoff 2003)
  - currency depreciation accompanying expansive monetary policy spills over into more inflation the higher the import share (Romer 1991)

Ought central banks to change their inflation objectives?

- Relative-wage argument in favour of higher targets
  - globalisation may entail large relative wage changes that may be hampered by *nominal* rigidities
  - but so far not much empirical support for large relative wage changes due to globalisation
  - and globalisation will proceed gradually

But there are also reverse arguments

- Ongoing terms-of-trade improvements reduce the risk that relative wage adjustments require nominal wage cuts
- Globalisation itself can reduce nominal rigidities
- Higher productivity growth means higher nominal wage growth at given inflation rate
- <u>Conclusion:</u> Difficult to argue that globalisation could motivate changes in inflation targets