

HAS GLOBALIZATION TURNED INFLATIONARY?

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I am glad to be with you this afternoon. Thank you very much, Andrea, for the invitation. In my presentation, I will be dealing with the main topic of this session, i.e., the question of the effects of globalization on inflation, as well as with the twin and topical question of this symposium, i.e., the ongoing financial crisis.

This afternoon, Benoît Mojon has given a very nice presentation on the topic of inflation and globalization. His main conclusion is that disinflation has been mainly due to monetary policy. I agree with this, but I would also stress that globalization has also played a significant role.

With regard to this question, it is important to study the channels of transmission, because I think that you could implement any kind of econometric work, but if it is a black box, or something close to a black box, you show nothing. And one ought to study carefully the channels of transmission between globalization and the level, the dynamics, the content of prices, as well as what I think is becoming the main problem, i.e., changes in relative prices.

I will begin with a few words about the channels of transmission. In the early 1990s, we had the feeling that globalization was helping monetary policy through four channels: First, price competition. Price competition introduced by globalization puts a cap, a ceiling on the rate of inflation. This was the nice story of the 90s: "Inflation is capped due to globalization." We have entered a world where all firms are price-takers. When I look at the current situation, I think that even monopolies are price-takers. One way to see this is to compare the way the current oil shock was accommodated. This oil shock was accommodated with a fairly low impact on wholesale and retail prices.

This was rather surprising, because if three years ago we had known that we would be facing such an energy shock, we would have anticipated a higher rate of inflation in most of our economies. In fact my view is that inflation, despite the fact that it has somewhat accelerated, has been kept under control. During the first two oil shocks of the 70s, there were a lot of firms that were price-makers. Now there are very few. I think that this has been used as a shield against the contamination from oil to global inflation, not a 100-percent effective shield, but a partial shield against a true rebound in inflation.

When we talk about competition introduced by globalization, there is a second argument which is very difficult to introduce into econometric works: the fact that globalization has increased overcapacity in many sectors of the economy. I am thinking of computers, automobiles, banking and finance. Generally speaking, banking and finance are not facing overcapacity at world level, but I think that in many banking and finance activities today, there is some overcapacity. Overcapacity is also introducing a cap on inflation and the possibility for some prices to decrease.

A third channel must also be considered: innovation, and therefore productivity gains. If we want to study the channel of transmission from globalization to inflation, we have to pass through the impact of globalization on competition and therefore on innovation and the fact that innovation is fuelling productivity gains.

This is the argument that was given in the US: when Alan Greenspan was talking about the new disinflation world for the US in the 90s, he was referring to Paul David's work on the industrial revolution at the end of the 19th century and in the early 20th century. He followed a Schumpeterian view of innovation where each wave of innovation (with a lag, called the Solow paradox) fuels productivity gains. I think that even if the Greenspan-David story is not directly linked to globalization, it is still somewhat relevant.

With reference to price competition, Dr. Mojon has discussed earlier wage competition and wage adjustment. By the way, if you look at the figures, wages in China have been adjusting rather quickly over the past couple of years. If the important variable here is the evolution of unit labor cost, when we look at the evolution of wages and wage policies in China it is really important to compare the adjustment of real wages with labor productivity gains. Once the increase in real wages in China is adjusted for productivity

gains due to both product and process innovation, you will see that wage adjustment is partially granted by the productivity gains.

The last channel, which links competition, globalization and prices, has to do with another aspect that we have not been talking about: tax competition. Globalization means tax competition, with adjustments on the low side of the tax. This could also, in some cases, be a way through which globalization is capping the rate of inflation in the economy. These are the positive effects of globalization on price stability.

But there is another very important aspect, which I think is at the core of the debate: the difference between global effects and relative prices. If we look at what is occurring today, we see a very dramatic increase in the relative prices of energy and food. This is the world in which we are living and in which we will continue to live for some time, for years perhaps. By the way, the relative prices of energy and food are the successor of another relative price which was important before, the relative price of services versus industry. Because productivity gains are generally smaller in services than in industry, for the past twenty years we have been seeing an increase in the relative prices of services as opposed to industry prices. This could continue, but for me today when we look at the dynamics of our economies the main relative prices are those of energy and food. The problem is that there is no self-regulation for these products. In the case of energy products (including oil), food and at least some raw materials, both demand and supply elasticity are low, even with a long lag.

I believe that if ten years ago we had thought that a barrel of oil would reach \$100 and more we, as economists, would have anticipated that a supply reaction would stabilize prices. Did we see those reactions over the last five years? If you look at the scale of new capacity, very little was put in place as a way to benefit from these high price levels. What we saw is some kind of substitution effects among energy sources rather than a capacity effect.

All the debate about short-term versus long-term elasticity, for both demand and supply, means, to me, that both elasticities will stay rather sticky and we are going to live in a world where the relative prices of energy and food and some other raw materials will stay very high.

To explain why this is important, I need to introduce something that is crucial when you ask people about their perception of inflation. What is it in people's minds? When we look at the data for all countries, there is a gap between perceived inflation and actual inflation. Consider my country, France, where perceived inflation is about two times actual inflation. I think that the increase in the relative prices of food and energy, which are substantial products, plays a very important role in maintaining this gap or even, in some cases, increasing the gap between perceived inflation and actual inflation.

For the eurozone countries, it is often said that the launch of the euro has created such a gap. It is true if you take France, Italy, Germany, Slovenia and perhaps Malta and Cyprus, to include the last two countries that joined the eurozone. In all eurozone countries the launch of the euro has created or increased the gap between perceived inflation and actual inflation. Why? Because people, partially rightly, had and still have a feeling that the transition to the new currency was used to increase some prices, especially what I would call high-frequency purchases. You buy bread every day, but you do not buy a car every day. And if we look at the impact of the euro on absolute prices and relative prices in most eurozone countries, we see an increase in prices of high-frequency consumption and a possible decrease, due to the competition introduced by the euro, in the prices of low-frequency purchases such as cars, electronics, etc.

Therefore, when you look at the official measure of inflation, the euro effect was very small compared to consumers' perceptions of that effect. I remember the data that were published in 2002-2003 after the launch of the euro notes and coins which revealed that the impact of the euro on inflation was then 0.2-0.3 percent in annual terms. But in people's minds it was much more than this amount, due to the distinction that I have made between high-frequency consumption and low-frequency consumption. This is a very important distinction, and I do not know of any econometric model that uses it in order to understand the reaction of the public opinion in our countries after the launch of euro coins and notes.

I must make two additional remarks on this topic before I conclude with some comments on the financial crisis. The first remark is on asset inflation. I believe that there is a gap between the central bank speech

and the reality in which we are living. We live in a world where the main inflation and deflation forces are in asset markets, such as real estate, raw materials, gold, the bond market and in some cases the stock market. We have been passing, over the last fifteen years, from one bubble to the next, and we will continue to pass from one bubble to the next. The burst of the internet bubble launched the development of the real estate bubble. The burst of the real estate bubble led to the development of the bubble on emerging financial markets, raw materials, oil, etc. We will continue to pass from one bubble to another.

For me the problem of inflation is now more serious with assets than with goods and services. And it is very difficult for central bankers to acknowledge this transition. Central bankers of course know we are living in this brave new world where asset inflation and deflation generate all the wealth effect, positive or negative, that we have been talking about. But it is very difficult for central bankers to acknowledge it fully: it is already very difficult for any central bank to monitor and control prices of goods and services indirectly, but it is much more difficult to try to monitor and control asset prices indirectly. Therefore, I think there is a gap between the speech and the reality of monetary policy. At some point this gap will have to be closed—if I may say so—for the sake of the credibility of monetary policy and monetary governance of our system.

As I have said earlier, my view is that the main question has to do with relative prices rather than with global inflation. It is very difficult for monetary policy to care about relative prices. Also, it is not the goal of monetary policy to do so. In terms of impact on public opinion, relative prices, especially in a situation where the rising prices are energy and food prices, are more important in the minds of the people than some other prices.

In terms of the ability of central banks to control and monitor this situation, I remind you of a statement by Paul Samuelson which I like very much: "If we have two eyes"—he said—"it is because we ought to look at at least two indicators." I think that central bankers must not look at only one definition of inflation. They must look at and monitor several definitions of inflation. There is the debate of core versus headline inflation. But they ought to look more and more at asset prices and the wealth effect generated by those asset prices, even though they do not control asset prices.

Just a few words on the crisis. About the dollar: I am rather pessimistic about the evolution of the dollar, for the same reasons given by Korkut Ertürk. My question is: Do we have any other option besides Dr. Ertürk's SDR solution?

I believe that the main issue here is whether, at some point, the US administration is going to become concerned about the fall of the US dollar. Is there an exchange rate threshold beyond which Americans will think that the cost of a falling dollar would be greater than its benefits? This is for me the main problem, because if the answer is yes, there could be a threshold: \$1.60, \$1.65 per euro, or more, I do not know where the threshold is. If we could say that there is a threshold above which the cost of the falling dollar is too high for the US, we could envisage a coordinated intervention by the G-7 central banks.

You must recall that the situation with exchange rates in October, 2000, was the reverse of the present one: the dollar was too strong and the euro too weak. At that time, we had rather effective central bank intervention. Why was it effective? Because the Fed supported the ECB initiative. Indeed, we had the ECB, the Fed, the Bank of Japan, the Bank of Canada, the Bank of England: the G-7 central banks.

It would be totally ineffective for the ECB to intervene in the foreign exchange market without the Fed. This is the reason why, for me, the big question is when the falling dollar will become too costly for the US. Why could it become costly for the US? The US must import 700-750 billion dollars per year to finance its current deficit, either through direct investment or portfolio investment. Direct investment is going to be fuelled by the falling dollar. But what about portfolio investment? If the US wants to continue to attract portfolio investment in a situation where the Asian central banks do not want to accumulate more US dollars, the only possibility for the US to attract more portfolio investment is an increase in US long-term rates. Therefore, we must couple the possibility that the US dollar will continue to go down with a scenario where US long-term rates will go up. This will be bad for US growth. This is one cost for the US if the dollar continues to fall.

The second cost is the loss of the reputation and image of the dollar as a currency. The third cost is the financing of the US current deficit. Deficits are always financed, and the problem is to know by whom and at what price. This is why I was talking about US long-term rates. Perhaps I am less pessimistic than Dr. Ertürk in saying that there will be a threshold above which the Fed will be with us in order to intervene on the foreign exchange market if it is necessary. The problem for Europe is that we must not be dead before reaching this threshold, dead in terms of price competitiveness and growth. The question is whether the tolerance threshold is about the same for Europe and for America. Apparently we cannot assume that it is the same.

Concerning the other aspect of the financial crisis, I want to make the following comment. If you look back at international coordination over the past 30 years, the only field where we have had an effective international coordination is banking regulation. For me, all the G-7 - G-8 exercises have been, in terms of effectiveness, useless including the Louvre agreement (1987) when they decided to implement a target zone for the dollar and the Deutsche mark (and the yen). This was effective for a few weeks. In the medium term, it was totally ineffective.

Again, the only field where, at the world level, we have been able to agree on an effective coordination has been the Basel Banking Supervision Committee (Basel I and Basel II).

In a report to be presented to the French Prime Minister in a few weeks, I have been dealing with the way to improve the working of rating agencies, which is a topical subject. Is it necessary to implement a standard for bank liquidity? As Dr. Terzi said, Basel I and Basel II deal with solvency, not with liquidity.

There was a meeting in January, 2008, in London between Mr. Brown, Mr. Prodi, Mr. Sarkozy and Ms. Merkel about exactly these topics: Must we implement an international standard for banking liquidity? It will be difficult to find an agreement. Even within Europe there is no convergence on banking liquidity ratios. If you look at the 27 members of the EU today, only two-thirds of them, or 18 countries, have some banking regulations for bank liquidity, and they are totally different from one country to the other. If you compare France, Germany and Italy for liquidity ratios, there is no harmonization at all. Before talking about a possible world-wide harmonization at world level concerning bank liquidity, it would perhaps be nice to start in Europe and to see if it is desirable and possible, given the fact that we want to implement a true single market for banking and financial services.

There are also other topics on which our report for the French Prime Minister is making proposals. Today, we have not discussed sovereign wealth funds, which are part of both the solution and the problem. The rise of sovereign wealth fund is a solution for banks that today need more capital. Even in Switzerland, Germany, France, the UK and the US, many banks are searching for recapitalization through the money brought by sovereign wealth funds. Therefore, it is a solution in the short term. It could be a problem, a geopolitical problem, for the medium and long term, however, and we must define the rules of the game here. It is a problem that must be dealt with at world level, not only by the G-7 - G-8. I frankly think that the G-7 - G-8 is dead, because it is no longer representative of the world economy. Why have Russia at the table and not China? Even when China is invited, it is not a full member, as opposed to Russia. This cannot continue; we have to move to the G-13, G-15 or G-18 (I do not know what the optimal number is) to implement a better and more representative international coordination.

Concerning sovereign funds, the debate that is going to be taken up in April, 2008, in Washington, D.C., is about a code of conduct for sovereign wealth funds. In such a code of conduct what could we agree on? We could agree on at least three topics: transparency of the sovereign wealth funds concerning their investment policy, governance of the funds and reciprocity. If we allow China to buy our banks or part of our banks, we must ask China to be as open as we are: reciprocity.

What I am saying is that when we look at all these debates we have to give concrete answers. I think we could build a matrix to answer the topical subjects in light of this financial crisis. At what level must we deal with the issues: the world, Europe or the national level? Through what kind of answers? Again, three options: formal regulation, code of conduct ("soft" regulation) and self-regulation.

With self-regulation we rely on market answers. Formal regulation is of the kind of Basel I, Basel II. And it will soon be necessary to adapt it, in two-three years, to a new Basel III. It is like the movie sequels Rocky I, Rocky II, etc. In Europe, Basel II started in January of this year. In the US, Basel II will start next year. We cannot change Basel II today, even though we know that there are already some changes to introduce into banking regulation in light of the current financial crisis. We have to wait some time until the crisis is over.

The code of conduct is something between self-regulation and formal regulation. The code-of-conduct approach is proposed by public authorities, but it must ultimately be accepted by the market, by the practitioners. When we discuss how to improve the working of rating agencies and how to fix the rules of the game for sovereign wealth funds, we have to push the idea of an effective code of conduct, because in this area self-regulation will not be sufficient and formal international regulation is impossible.

It is not feasible to enact any kind of formal regulation to regulate rating agencies at world level. On this point, I think the IMF has to update its agenda. Dominique Strauss-Kahn was elected to manage the IMF, I guess, to give a new impetus, a new role to the IMF, in relationship with the management of the financial crises. May I say that this work is very interesting, but, by definition, very difficult. If you look back at all the works implemented by the IMF over the last fifteen years concerning the possibility of forecasting financial crises, the results are somewhat disappointing. We even have some difficulty to "forecast" the crises of the past, when we look at the econometric sample.

I think this is going to be a very tough political debate. Do we create for finance something similar to the World Trade Organization? We are still talking about the WTO, even though today it is rather weak. But despite the fact that today it is weak, its purpose was not weak: to create rules, discipline and ways to implement this discipline. The problem for the next couple of years is whether we can transform the IMF into a financial WTO. Do we create a world finance organization which is not added to the IMF, but which would be a way to renovate the IMF? Despite the fact that I am French, I do not like "institution inflation," and therefore I think that the problem is not to create new institutions but rather to regenerate existing institutions. Thank you very much.