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Globalization Aids Monetary Policy, Says Former IMF Research Chief

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JACKSON HOLE, Wyo. -- Globalization has made monetary policy easier in recent years, and central bankers should respond by exhibiting greater flexibility in the face of certain shocks like imported deflation from China or higher oil prices, a former research director at the International Monetary Fund said Saturday.

"Globalization creates favorable milieu for maintaining low inflation by flattening the output-inflation tradeoff faced by central banks," Harvard Professor and former IMF Research Director Kenneth Rogoff wrote in a paper delivered at the Federal Reserve Bank of Kansas City's two-day symposium on globalization in Jackson Hole, Wyo.

Mr. Rogoff added, "this flattening, in turn, makes commitments to low inflation more credible and more durable."

But he cautioned that central banks should keep their eyes focused on domestic price pressures and not be overly distracted by global capacity issues.

"Global excess capacity ... may prove useful in forecasting external price pressures," Mr. Rogoff wrote. "However, these interesting new forecasting concepts in no way overturn the basic proposition that any central bank, no matter how small or open its economy, can always stabilize domestic prices at medium to long-term horizons, should it choose to do so," he added.

Globalization may affect policy in the more immediate term by allowing central banks to permit inflation to deviate from its target -- both high and low -- in response to shocks.

"There is ... a much stronger case for incorporating terms of trade shocks, allowing for example large oil price shocks to temporarily raise inflation, and unexpectedly favorable shifts in goods terms of trade ("China deflation") to push inflation below target," Mr. Rogoff wrote.

For all its benefits, one possible drawback from globalization is volatility in asset prices, Mr. Rogoff suggests, an effect that is likely to linger. Globalization has helped keep long-term interest rates and risk premia down, Mr. Rogoff noted, "thereby inflating the prices of long-lived assets not least including housing and equity."

Those assets in turn "become more sensitive to perceived changes to risk and the trajectory of interest rates," Mr. Rogoff explained, "offsetting the volatility reduction that would otherwise come from lower macroeconomic volatility."

Higher asset prices, meanwhile, have helped spur current account imbalances, Mr. Rogoff said, including the "humongous" U.S. current account deficit. He cautioned that while there have yet to be adverse effects, that could change.

"Whereas one can argue that the effects until now have been relatively benign, it remains very much an open question of what will happen if the system is stress tested, say by a combination of housing price collapse in the United States combined with a sharp slowdown in growth in China," Mr. Rogoff wrote.

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