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Monetary Policy in an Interdependent World

by Sandra Pianalto

While central bankers must focus on delivering price stability and other mandates in their own countries, they must also monitor international developments closely because national trade and financial markets have become increasingly interconnected. Sandra Pianalto, president and chief executive officer of the Federal Reserve Bank of Cleveland, explores how the globalization of financial markets could affect U.S. monetary policy and explains how a commitment to price stability and policy transparency can help monetary policymakers deal with challenging international developments. A version of this speech was presented to the Marshall Forum on Transatlantic Affairs in Tremezzo, Italy, on March 18, 2006.

The key objectives of the Federal Reserve's monetary policy are to maintain long-term price stability and to foster maximum sustainable economic growth and high employment in the United States. As a member of the Federal Open Market Committee—the group that sets monetary policy in the United States—I conceive of these policy objectives solely in national terms—inflation and growth rates in the United States. Nevertheless, I realize that if I am to achieve these objectives, I cannot ignore international developments. We live in a closely integrated world, and it becomes more so every day.

Today, I will describe how I think about monetary policy in an interdependent world. First, I will explain how policymakers throughout the world have reached a remarkable consensus on the importance of price stability. Then I will explore how the globalization of financial markets could affect U.S. monetary policy. Finally, I will explain how a consensus for price stability has made monetary policy more predictable and, therefore, more effective in dealing with any type of global adjustment that we might face.

Of course, the views that I express today are my own. I do not presume to speak for any of my colleagues in the Federal Reserve System.

The Consensus for Price Stability

Over the past couple of decades, monetary policymakers, government officials, and the public have come to recognize that long-term price stability is the best contribution that a central bank can make to a nation's economic prosperity. By long-term price stability, I mean a rate of inflation that consistently remains so low and stable that it does not become embedded in business or household expectations and disrupt their economic decisions.

Attaching a precise number to this definition of price stability is very difficult, and central banks differ in many of the mechanical details. Nevertheless, those that focus on maintaining a low stable rate of inflation generally appear to be satisfied with an inflation rate in the 1 percent to 2 percent range.

Over the past 25 years, the world's monetary authorities have been very successful at reducing the overall global rate of inflation. Among the industrialized countries, the rate of inflation fell from 9 percent in the first half of the 1980s to 2 percent early in this decade. The inflation performance among developing countries was even more impressive. Their inflation rate fell from roughly 30 percent to 6 percent over the same time period. In many countries and regions, central banks have achieved this goal through institutional independence, demonstrated commitment, and clear communication.

To understand why long-term price stability is so important to a nation's economic prosperity, we need only recall a time when price stability was not the global norm. While this is not a uniquely American story, I will describe the U.S. experience, since I know that situation best. During the so-called "Great Inflation" of the late 1960s and the 1970s, confidence in U.S. monetary policy was badly shaken. Faced with a series of financial crises and energy-price shocks, Federal Reserve policymakers did not follow a consistent and clearly articulated policy. They alternatively tightened and loosened monetary policy in a futile attempt to achieve conflicting economic targets, with the result that they attained none of them.

Inflation reached double-digit levels, and the United States experienced the longest and deepest recessions of the postwar period. Because businesses and households expected inflation to keep rising, they often diverted resources away from growth-enhancing investments to activities that shielded their wealth. Ultimately, the potential for long-term economic growth in the Unites States slowed.

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Things changed for the better beginning in the early 1980s. During the chairmanships of Paul Volcker and Alan Greenspan, the Federal Reserve lowered core inflation in the United States from approximately 13 percent in 1980 to around 2 percent in recent years. This outcome was achieved even in the face of periodic energy-price spikes, stock-market disruptions, international financial crises, and recessions.

It was not an easy task. Inflation did not decline along a smooth, linear path, but the FOMC quickly responded to deviations in the process and kept its focus on long-term price stability. As time went on, economists noticed that people's inflation expectations no longer reacted very strongly to financial crises, energy-price shocks, or dollar depreciations.

Over these 25 years of focusing on price stability, recessions became less frequent and comparatively mild. By the 1990s, long-term growth picked up. Policymakers began to associate price stability with long-term economic growth and employment. Economic studies confirmed this connection. Countries with excessive rates of inflation find it harder to sustain high rates of economic growth than countries with low rates of inflation.

The relationship between price stability and economic growth is important, because even small changes in a country's long-term economic growth can have large effects on the well-being of its people over their lifetimes. An economy growing at $3^1/_2$ percent per year will double its citizens' standard of living in about 20 years, whereas an economy growing at only 2 percent per year does so in about 35 years.

So my goal as a monetary policymaker is to promote maximum sustainable long-term growth in the United States through price stability. I conceive of these objectives only in domestic terms—as do my counterparts at the European Central Bank, the Bank of England, the Bank of Japan, and at most other central banks. But like central bankers across the globe, I realize that I cannot hope to achieve these important domestic objectives if I ignore international developments. We live in a closely interconnected world, especially in terms of financial markets.

■ Globalization and Monetary Policy

The globalization of world markets has been progressing at least since the end of World War II. We usually measure this process in terms of goods and services trade. Over the past 50 years, international trade has steadily grown, generally at a faster pace than world output.

We still face many lingering challenges and some occasional turmoil, but those countries that have embraced free international trade have seen their standards of living rise substantially. The gains have been so great that we increasingly find fewer closed, command-style economic systems. The People's Republic of China, for example, is rapidly adopting market economics, although it still has a ways to go. China now has a strong global presence and offers an alluring market.

Although we usually equate globalization with international trade, the markets for goods and services are not the only ones taking on a global character. Recently, globalization has entered a new phase; financial markets are becoming increasingly interconnected. According to the International Monetary Fund, over only the last 15 years, the gross external assets and liabilities of industrialized countries—and to a less extent emerging-market economies—tripled, on average, as a percent of GDP.[1] In the United States, for example, gross foreign assets and liabilities equaled 80 percent of GDP in 1990; today they are nearly two and a half times bigger—exceeding 190 percent of GDP. To be sure, international investors do still favor the familiar—they still exhibit a home bias in their portfolio choices—but they are increasingly willing and able to seek out higher returns abroad.

The globalization of financial markets has direct implications for central banks. Just as international trade makes goods prices more sensitive to worldwide demand and supply pressures, the globalization of financial markets will tie interest rates in any single country more closely to interest rates across the globe and, in the bargain, leave exchange rates more sensitive to financial flows.

The United States has been an important participant in this process of financial globalization. A nearly unbroken, 23-year string of current-account deficits has left foreigners holding substantial—and still growing—claims on the United States. In 2005, these claims were estimated at more than $3 trillion, or 26 percent of U.S. GDP. When the United States runs a current-account deficit, it imports more than it exports and pays for the difference by issuing financial claims to the rest of the world. These include U.S. government securities, corporate stocks and bonds, and bank accounts. When foreigners acquire these claims, they channel their savings into the United States.

Economists have offered many reasons for these current-account imbalances. Some say that U.S. consumers do not save enough and that the U.S. government borrows too much. Others claim that foreign economies do not provide attractive investment climates or that foreign consumers save too much. Still others contend that our current-account deficits reflect the strategic actions of foreign central banks that acquire dollars by impeding the way their exchange rates adjust.

The list of possible explanations is long, and the contributing factors are complex. I am not sure that there is one ultimate cause for these patterns, but that does not really matter. The important point is that in a closely interconnected world, people can buy and sell and borrow and lend across the globe. They channel their investments where they believe returns will be greatest in proportion to the risk. The consequences of their actions accumulate in complicated ways that will often produce large current-account deficits and surpluses. In fact, in a closely integrated world, we should expect to see sizeable current-account imbalances.

Like many observers, I realize that our current-account deficits cannot keep growing indefinitely. The rest of the world will not continue to accumulate ever-growing financial claims against the United States and channel its savings here. At some point, international investors—including governments—will become reluctant to add additional dollar-denominated claims to their portfolios. They might even want to diversify out of dollars to some extent. At that point, higher interest rates on dollar-denominated assets and, possibly, a decline in the spot value of the dollar will be necessary to overcome their reluctance.

I do not claim to know when we might reach this point or how these events might play out. No one does. Many people thought that a reversal was beginning in early 2002, when the current-account deficit began rising above 4 percent of GDP, and the dollar started to depreciate. Yet the reversal did not happen.

The chances that international investors will start placing funds elsewhere will undoubtedly grow as economic activity outside the United States continues to expand. Since 2000, U.S. economic activity has generally outpaced economic activity in much of the rest of the world. As economic growth throughout the world—notably in Europe and Japan—continues to accelerate and opens up attractive alternatives for investment, the United States might find it increasingly difficult to attract inflows of foreign savings.

Should these international developments start to unfold, I cannot ignore them if I hope to attain my domestic economic objectives of price stability and maximum sustainable economic growth with high employment. This situation poses two interconnected challenges: First, should international investors seek a risk premium to compensate them for taking large dollar positions in their portfolios, they will encourage a dollar depreciation and might exert some upward pressure on U.S. interest rates. A dollar depreciation could eventually raise the dollar price of all U.S. traded goods—imports, import-competing goods, and exports. The extent to which higher prices for these traded goods then pass through to the overall U.S. inflation rate will depend critically on how monetary policy responds. Such a development would complicate the task of maintaining domestic price stability.

The second challenge is not directly "monetary" in nature, but it is intertwined with it. To achieve a fundamental change in the U.S. current account, domestic savings—both household and public—must rise, or domestic investment will fall, and resources—both labor and capital—must shift to expand production in the export and import-competing sectors of the U.S. economy. How quickly and smoothly these adjustments take place will depend on the severity of frictions in the U.S. economy. Frictions are always with us. Wages and prices are often set by contract or custom, which slows their response to changing economic circumstances. Information is typically costly to acquire and takes time to disseminate, and just the act of adapting to economic change involves resource costs that slow the adjustment process. Yet a credible, predictable monetary policy can help reduce the impact of such frictions.

■ A Predictable Monetary Policy

Although I believe that current international imbalances are not sustainable indefinitely, and even though I would not venture to predict when a reversal might take place, I am optimistic that the adjustment process will be orderly. I predicate my optimism on history and on the recent behavior of central banks.

Large, persistent current-account imbalances are not a new phenomenon. We experienced them in the late nineteenth century, during the 1920s and 1930s, and again during the Bretton Woods era—the late 1940s to the early 1970s. Michael Bordo, a noted economic historian from Rutgers University and a visiting scholar at the Federal Reserve Bank of Cleveland, has shown that markets can adjust to international imbalances in an orderly way when they have confidence in underlying monetary institutions.[2]

Over the last 25 years, the Federal Reserve and central banks around the world have increased the credibility and the predictability of their monetary policies, primarily by fulfilling a commitment to price stability. This predictability can enhance the efficiency of monetary policy. When our actions are transparent and our pronouncements are credible, the public is less likely to incorporate temporary, relative price changes into their long-term inflation expectations, as they unfortunately did in the 1970s. When policy is predictable and expectations are benign, small policy responses to economic shocks can have faster, favorable price effects with lower costs in terms of output and employment, as we saw in the 1990s. Maintaining a credible commitment to low and stable inflation is the best contribution that central banks can make to the challenge of global adjustment.

■ Conclusion

I do not intend my remarks today to be a forecast of likely developments in global markets. Instead, I intend them as a comment on the growing importance of globalization and on the achievements that central banks have made over the last 25 years. Monetary policymakers, like me, who hope to achieve long-term price stability and maximum sustainable economic growth with high employment can no longer ignore the interconnectedness of global markets. In that respect, the U.S. current-account deficit and associated global savings and investment patterns could present some serious challenges as worldwide expansion continues. Yet we face them on the best possible terms. Through a 25-year commitment to price stability and policy transparency, central banks have improved the predictability—and the efficiency—of monetary policy.

■ Footnotes

1. International Monetary Fund, "Globalization and External Imbalances," *World Economic Outlook*, (April 2005), pp. 109–56. See also: International Monetary Fund, "Global Imbalances: A Savings and Investment Perspective," *World Economic Outlook*, (September 2005), pp. 91–124.

2. Michael D. Bordo. 2006. "Globalization and Imbalances in Historical Perspective," Federal Reserve Bank of Cleveland, *Policy Discussion Papers*, no. 13.

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