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Panel Remarks

Donald L. Kohn

The global economic landscape has been transformed in recent decades by the increasing international integration of markets for goods and services, factors of production, and finance. That process has been spurred by several developments, among the most notable being the opening of previously closed economies; the reduction of tariff and regulatory barriers in open economies; declines in the cost of transporting goods, services, and information; greater mobility of capital and labor; and the creation of new ways to package and trade risk on financial markets. The closer integration across national borders has increased the exposure of economies to changing conditions abroad—including economic shocks and changes in the pricing and trading of financial assets. In addition, relationships among interest rates, exchange rates, spending propensities, resource utilization, and price-level pressures have evolved as economies have opened up.

Nonetheless, I agree with the thrust of the chapters in this conference volume—if there is a surprise, it is in the apparently gradual and limited effects of those transformations on domestic economic activity and inflation. The basic structure and relationships of the domestic economy as they bear on monetary policymaking remain intact. Policymakers must judge the actual and expected relationships between aggregate demand and potential domestic supply and, using that judgment, assess the likely course of inflation; they are able then to adjust the short-term policy interest rate to keep prices stable and the economy operating near its potential. Although for-

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eign developments have come to play a larger role in these judgments, most key relationships have changed only gradually and in predictable directions. Given that exchange rates fluctuate freely, monetary policymakers continue to exercise control over key variables and should be held accountable for results in their respective economies.

However, despite the gradual evolution, global integration has had some potentially important implications for policymaking that we need to study further. As I have already noted, greater integration opens economies to shocks originating abroad or on global markets. As risks become more broadly shared in more-complete markets, and as investors and borrowers increasingly operate in many markets at the same time, the financial arena becomes an important channel for the international transmittal of economic developments. Also, the greater integration of global flows of goods and services means that a demand or supply shock in one country or region will affect prices and quantities elsewhere to a greater degree than previously. Vulnerabilities encompass not only standard supply and demand shocks but also changes in attitudes and expectations that can be transmitted rapidly to multiple markets and currencies. For example, although businesses have been operating increasingly integrated supply chains for at least a decade, many countries at the outset of the U.S. crash in dot-com equities saw themselves as largely isolated from it. But they quickly found themselves subject to changing attitudes in equity markets around the world and vulnerable to shifts in demand that moved through long, integrated supply chains in ways that might not have been obvious before the event.

Moreover, the conduct of monetary policy may come to face different, and in some respects greater, sources of uncertainty as economies continue to integrate. Exchange rates, for example, are more important for policy, but they seem to be among the less well understood asset prices, rarely responding as models predict they should to changes in actual or expected interest rates. For example, in 2001, the Federal Reserve reduced its policy rate aggressively—more so than other currency areas—to combat recession, but the dollar rose, blunting the effect of the easing. In addition, exchange rates appear to respond to financial capital flows—to demands for financial assets and financial claims on real assets—as well as to the current account and trade balance determinants so prominent in our models.

More generally, the behavior of many asset prices appears to have evolved as markets have become more complete and integrated. Interest rates and equity prices seem to be more correlated across markets. Some of this greater correlation may be related to the greater openness to common shocks. But some of the rise in correlation undoubtedly also reflects the increased ability of market participants to arbitrage across larger numbers of disparate markets.

Although the coefficients in our models are mostly shifting slowly, the pace and degree of evolution are not always easy to predict. Major developments—such as the extraordinary decreases in the cost of transmitting data and the opening up of Eastern Europe, China, and India—are reshaping trade flows and the domestic influence of international developments in ways that may surprise us.

Indeed, a global dimension seems to be part of some of the more puzzling macroeconomic developments over the past several years: the growth and persistence of the U.S. current account deficit; the restraint on labor compensation and increase in business profits in so many locations; the damped global demand from businesses for capital goods despite high profitability; and the long period of low long-term interest rates, damped volatility, and low risk spreads in most financial markets. Many of these developments occurred simultaneously in a number of regions of the world and were unexpected or difficult to explain using purely domestic factors. Many involved cross-border flows of goods, services, labor, physical investment, and financial capital in ways that probably would not have been feasible ten or twenty years ago.

But as I suggested at the outset, these puzzling or unprecedented elements of globalization have not revolutionized the conduct of monetary policy. The changes have mostly been gradual, with modestly evolving effects on the needed policy settings. And none of these developments mean that monetary policymakers cannot still be held accountable for the stability of prices and output in their local economies. But as the puzzles suggest, we do need to recognize that the pace of global integration has picked up and that our understanding of its implications is far from complete. As policymakers and as economists, we need to keep working on enhancing our knowledge and our abilities to integrate shifting international influences into the conduct of monetary policy.

Rakesh Mohan

Introduction

In these panel remarks I will try and present the key dilemmas we are facing in India, but that I believe almost all the developing countries in Asia are also facing. The result is that none of us are really following what seem to be well accepted principles of monetary policymaking. And yet we have collectively exhibited the highest growth in the world in the last twenty-five years and over, while also experiencing generally low inflation.

In recent years, the growing integration of goods and financial markets has transformed the environment in which monetary policy operates. While monetary policy has been successful in keeping inflation low in many countries since the early 1990s, some are arguing that its ability to do so in the

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