

Reducing Inflation's Bite

As globalization has knit the world closer together in recent decades, inflation has fallen sharply in many countries.

The seven largest developed nations recorded average annual inflation of 10.2 percent from 1973 to 1983. Since 1995, their average rate has declined to just 1.8 percent a year. (See *Exhibit 2 on page 8*.)

Nearly all theorists recognize that inflation is largely a monetary phenomenon, but globalization changes the economic environment in which central banks operate. In a world where nations compete for investment dollars, the prospect of rapidly rising prices will spark capital flight to countries with more stable money. Central banks can't afford to allow inflation to exceed the global norm.

Cheap imports, moreover, have meant bargains for consumers. Forced to match foreign competition, domestic producers lowered costs by improving management, adopting new technologies and buying cheaper inputs overseas. Specialization added efficiencies by allowing labor, capital and other productive factors to flow toward centers of comparative advantage, where they could produce the most output at the lowest relative cost.

By exerting monetary discipline and spurring productivity growth, globalization has led to more stable prices. The U.S. has found itself with tamer inflation and faster growth than would have been possible without globalization.

A.T. Kearney Inc. and *Foreign Policy* magazine have developed a globalization index that ranks 62 nations on such factors as openness

to trade and investment, Internet access, cross-border communication and travel, and involvement in international organizations. Singapore, Ireland and Switzerland stand out as the world's most globalized nations. The United States ranks a very respectable fourth—off the charts in technology but lagging the leaders in trade, foreign direct investment and treaty commitments.

France, Germany and Japan post middling scores, largely because of lingering protectionism. Russia, China, Brazil and India are among the least globalized economies, indicating they still have a long way to go before full integration into the world economy.

Nations in the top quarter of the A.T. Kearney rankings did better than those toward the bottom in maintaining sound money, as measured by the Fraser Institute's Economic Freedom of the World index. The United States sits atop the Fraser standings, giving new meaning to the old saw about being sound as a dollar. Other sound money stars include Singapore, Sweden, Denmark and Finland—all highly globalized.

Throughout the A.T. Kearney rankings, price stability goes hand in hand with globalization. Nations in the bottom quarter had average inflation of 10 percent from 2001 to 2003. Rates tend to fall as nations globalize, reaching an average 2.3 percent for the top quarter.

Although the evils of inflation can't be denied, some governments are still tempted to pump up the money supply as a short-term palliative for sluggish growth, unemployment or ballooning fiscal deficits. When inflation gets out of hand, it erodes the value of money, destroys

savings and corrupts the incentives that direct the efficient allocation of resources.

Sound money, on the other hand, is an asset to an economy. It provides companies and individuals with a stable unit of value, so decisions about spending, saving and investing can be made on a reliable economic basis.

Globalization makes low inflation imperative, but nations have pursued monetary discipline in a variety of ways. The European Union institutionalized German-style monetary policy when it created a continental central bank in 1998 and gave it the sole mandate to maintain low inflation.

Mexico, once prone to severe bouts of inflation, achieved its smallest price increases on record in 2005—just 3.3 percent. The process of restoring stable prices began with a 1995 constitutional amendment guaranteeing the central bank's independence from political interference.

Ecuador and El Salvador adopted the U.S. dollar as their currency, effectively putting monetary policy beyond the reach of national leaders. The governor of New Zealand's central bank can be fired for exceeding its inflation target.

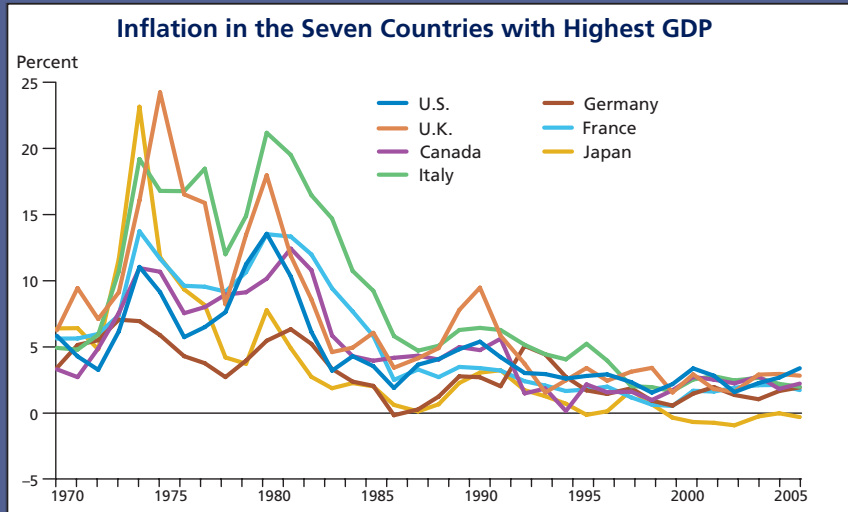
In the United States, the path to today's low inflation started in the early 1980s, when the Federal Reserve instituted tough policies to drive down double-digit price increases. The payoff has been average inflation of 3 percent a year for two decades.

Sound money does a world of good, but a nation's business climate also depends on other policies. Does globalization have an impact beyond keeping inflation in check?

EXHIBIT 2 The Path to Price Stability

Inflation is falling . . .

Over the past quarter century, inflation has declined sharply in most parts of the world, including the United States and other major developed countries.

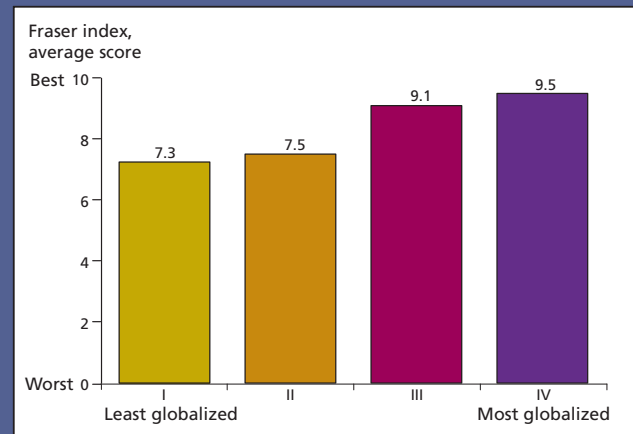
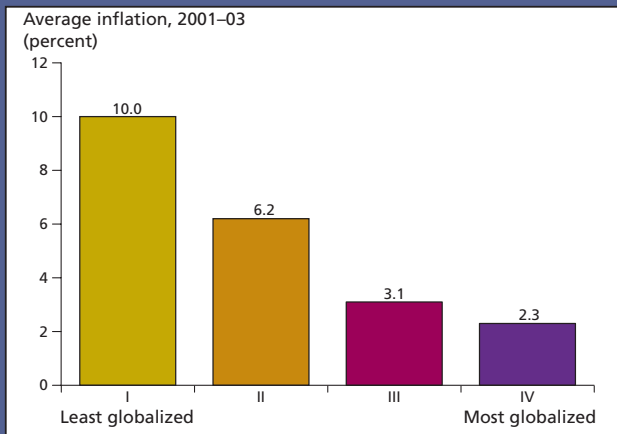


. . . with globalization playing a role . . .

Countries most open to international business tend to have far lower inflation rates than those that are closed (for rankings, see the box at the bottom). The pattern suggests globalization has contributed to price stability.

. . . in encouraging sound money.

The Fraser Institute's scores for sound money confirm the relationship between globalization and policies that keep inflation at bay.



For the past five years, A.T. Kearney Inc. and *Foreign Policy* magazine have ranked nations on globalization. The box below shows the pecking order for 2005, divided into quartiles, ranked from least (60) to most (1) globalized.

LEAST GLOBALIZED							
I		II		III		IV	
60	Iran	45	Argentina	30	Poland	15	Czech Republic
59	India	44	Thailand	29	South Korea	14	Norway
58	Indonesia	43	Saudi Arabia	28	Greece	13	Australia
57	Egypt	42	Nigeria	27	Japan	12	United Kingdom
56	Bangladesh	41	Sri Lanka	26	Italy	11	New Zealand
55	Brazil	40	Mexico	25	Spain	10	Finland
54	Turkey	39	Senegal	24	Slovak Republic	9	Austria
53	Venezuela	38	Morocco	23	Panama	8	Sweden
52	China	37	Ukraine	22	Hungary	7	Denmark
51	Peru	36	Tunisia	21	Portugal	6	Canada
50	Russia	35	Taiwan	20	Germany	5	Netherlands
49	Colombia	34	Romania	19	Slovenia	4	United States
48	Pakistan	33	Chile	18	Malaysia	3	Switzerland
47	Kenya	32	Uganda	17	France	2	Ireland
46	South Africa	31	Philippines	16	Israel	1	Singapore

MOST GLOBALIZED