

Globalization and Monetary Policy

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I want to talk about what I consider one of the biggest challenges my colleagues and I face: globalization's impact on the gearing of the economy and the making of monetary policy.

The literature on globalization is large. The literature on monetary policy is vast. But literature examining the combination of the two is surprisingly small.

What gives? Is the process of globalization disconnected from monetary policy? Is the business of the central bank totally divorced from globalization?

I think not. I believe globalization and monetary policy are intertwined in a complex narrative that is only beginning to unfold.

First, a definition, so that we can contemplate this matter together from common ground. There are many convoluted definitions of globalization. Mine is simple: Globalization is an ecosystem in which economic potential is no longer defined or contained by political and geographic boundaries. Economic activity knows no bounds in a globalized economy. A globalized world is one where goods, services, financial capital, machinery, money, workers and ideas migrate to wherever they are most valued and can work together most efficiently, flexibly and securely.

Where does monetary policy come into play

in this world? Well, consider the task of the central banker, seeking to conduct a monetary policy that will achieve maximum sustainable noninflationary growth.

Consider, for example, the experience of former Federal Reserve Governor Larry Meyer, articulated in his excellent little book *A Term at the Fed*. In it, you get a good sense of the lexicon of monetary policy deliberations. The language of Fed speak is full of sacrosanct terms such as "output gap" and "capacity constraints" and "the natural rate of unemployment," known by its successor acronym, NAIRU, the non-accelerating inflation rate of unemployment. Central bankers want GDP to run at no more than its theoretical limit, for exceeding that limit for long might stoke the fires of inflation. They do not wish to strain the economy's capacity to produce.

One key capacity factor is the labor pool. There is a shibboleth known as the Phillips curve, which posits that beyond a certain point too much employment ignites demand for greater pay, with eventual inflationary consequences for the entire economy.

Until only recently, the econometric calculations of the various capacity constraints and gaps of the U.S. economy were based on assumptions of a world that exists no more. Meyer's book is a

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real eye-opener because it describes in great detail the learning process of the FOMC [Federal Open Market Committee] members as the U.S. economy morphed into the new economic environment of the second half of the 1990s. At the time, economic growth was strong and accelerating. The unemployment rate was low, approaching levels unseen since the 1960s. In these circumstances, if you believed in the Phillips curve and the prevailing views of potential output growth, capacity constraints and the NAIRU, inflation was supposed to rise. That is precisely what the models used by the Federal Reserve staff were saying, as was Meyer himself, joined by nearly all the other Fed governors and presidents gathered around the FOMC table. Under the circumstances, they concluded that monetary policy needed to be tightened to head off the inevitable. They were frustrated by Chairman Greenspan's insistence that they postpone the rate hikes they were proposing, yet perplexed that inflation wasn't rising. Indeed, inflation just kept on falling.

If the advice of Meyer and other devotees of the Phillips curve, capacity constraints, output gaps and NAIRU had prevailed, the Fed would have caused the economy to seriously underperform.

Now, how was Greenspan able to get it right when other very smart men and women did not? Well, we now recognize with 20/20 hindsight that Greenspan was the first to grasp the fact that an acceleration in productivity had begun to alter the traditional relationships among economic variables. He understood the data and the modeling techniques of the Fed's research staff. But he was also constantly talking—and listening—to business leaders.

It is important to listen to the operators of our business economy. America's business managers have taken advantage of the phenomenon of globalization. Our business managers are the nerve endings in Adam Smith's invisible hand, stretching the fingers of capitalism into every corner of

comparative advantage worldwide.

Just consider what the fall of the Soviet Union, the implementation of Deng Xiaoping's "capitalist road" in China and India's embrace of market reforms mean to a business operator. Consider labor alone. In the early '90s, the former Soviet Union released millions of hungry workers into the system. China joined the World Trade Organization at the turn of the century and injected 750 million workers into play. And now India, with over 100 million English-speaking workers among its 1 billion people, has joined the game.

What does an American manager—paid to enhance returns to shareholders by growing revenues at the lowest possible costs—do? Because labor accounts for, on average, about two-thirds of the cost of producing most goods and services, a business manager will go where labor is cheapest. She will have a widget made in China or Vietnam, or a software program written in Russia or Estonia, or a center for processing calls or managing a back office set up in India.

Let me return home to Harvard once more and read you three quotes from Joseph Schumpeter, who taught here from 1932 until 1949, and I think you will get the picture.

First, from *Capitalism, Socialism, and Democracy*: "The fundamental impulse that sets and keeps the capitalist engine in motion comes from the new consumers' goods, the new methods of production or transportation, the new markets, the new forms of industrial organization that capitalist enterprise creates."

From that same page: "The opening up of new markets, foreign or domestic, and the organizational development from the craft shop and factory ... illustrate the same process of industrial mutation ... that incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one. This process of creative destruction is the essential fact about capitalism. It is ... what every capitalist concern has got to live in."

And from volume one of Schumpeter's *Business Cycles*: "A railroad through new country, i.e., a country not yet served by railroads, as soon as it gets into working order upsets all conditions of location, all cost calculations, all production functions within its radius of influence; and hardly any 'ways of doing things' which have been optimal before remain so afterward."

String the key operative phrases of those three citations together and you get the plot of this story, the plot of globalization: "The opening up of new markets, foreign or domestic ... revolutionizes the economic structure, ... destroying the old one, ... creating a new one.... [It] upsets all conditions of location, all cost calculations, all production functions, ... and hardly any ways of doing things which have been optimal before remain so afterward."

The destruction of communism and the creation of vast new sources of inputs and production have upset all the calculations and equations that the very best economics minds, including those of the Federal Reserve staff—and I consider them the best of all—have used as their guideposts. The old models simply do not apply to the new, real world.

You could sense something was wrong with the econometric equations if you listened to the troops on the ground, fighting in the trenches of the marketplace. This is what Chairman Greenspan does so well. And, though I am no Greenspan and never will be, this is what my colleagues and I on the FOMC do by making dozens upon dozens of calls to CEOs, COOs and CFOs of businesses, large and small, every month to prepare for FOMC meetings. We are simply observing managers at work expanding the capacity of our economy, expanding the gap between what their previously limited resources would allow them to produce and what their newly expanded globalized, technologically enhanced reach now allows them to produce.

From this, I personally conclude that we need to redraw the Phillips curve and rejig the equations that inform our understanding of the maximum

sustainable levels of U.S. production and growth.

Let me illustrate the point by citing another fine writer, Greg Ip. In yesterday's *Wall Street Journal*, he noted that the "U.S. economy grew at a 3.8% annual rate in the third quarter [of this year], its eighth consecutive quarter at about that pace. That's above what most economists consider the economy's potential growth rate—that is, what it can produce with existing capital and labor."

How can economists quantify with such precision what the U.S. can produce with existing labor and capital when we don't know the full extent of the global labor pool we can access? Or the totality of the financial and intellectual capital that can be drawn on to produce what we produce?

As long as we are able to hold back the devil of protectionism and keep open international capital markets and remain an open economy, how can we calculate an "output gap" without knowing the present capacity of, say, the Chinese and Indian economies? How can we fashion a Phillips curve without imputing the behavioral patterns of foreign labor pools? How can we formulate a regression analysis to capture what competition from all these new sources does to incentivize American management?

Until we are able to do so, we can only surmise what globalization does to the gearing of the U.S. economy, and we must continue driving monetary policy by qualitative assessment as we work to perfect our quantitative tool kit. At least that is my view.

—*Richard W. Fisher*

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